

***United States Court of Appeals
for the
District of Columbia Circuit***



**TRANSCRIPT OF
RECORD**

Brief for Kentucky West Virginia Gas Company, Petitioner

IN THE
United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

NO. 10401 APRIL TERM, 1949

KENTUCKY WEST VIRGINIA GAS COMPANY,
Petitioner

v.

FEDERAL POWER COMMISSION,
Respondent.

**PETITION TO REVIEW AND TO SET ASIDE ORDERS
OF THE FEDERAL POWER COMMISSION
ISSUED ON OCTOBER 8, 1948, NOVEMBER
26, 1948, AND JUNE 20, 1949.**

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I. JURISDICTIONAL STATEMENT

This is a rate case involving the rates of Kentucky West Virginia Gas Company (Kentucky). The jurisdiction of the Federal Power Commission exists under Section 5(a) of the Natural Gas Act for the determination of the reasonableness of the rates of Kentucky.

The jurisdiction of this Court exists under the provisions of Section 19(b) of the Natural Gas Act. (App. 9-10)

II. STATEMENT OF CASE

Proceedings in this Court:

This case arises upon a Petition to Review and to set aside Orders of the Federal Power Commission issued on October 8, 1948, and November 26, 1948, and June 20, 1949.

The Petition to Review was filed on August 18, 1949 and within sixty days after the final Order of the Commission, issued June 20, 1949, upon the Petitioner's initial application for rehearing filed October 29, 1948.

Proceedings before the Commission:

Kentucky West Virginia Company (Kentucky) owns and operates extensive natural gas properties for the production and transmission of natural gas in the State of Kentucky. The larger portions of its sales are to Pittsburgh and West Virginia Gas Company (Pittsburgh) and Louisville Gas and Electric Company (Louisville). Pittsburgh is an affiliate of Kentucky. Louisville was formerly an affiliate of Kentucky, but the affiliation has been terminated since the record in this case was closed.

Kentucky sells gas to Pittsburgh in interstate commerce, and Pittsburgh in turn sells gas in interstate

commerce to Equitable Gas Company (Equitable), which is also an affiliate of Kentucky and of Pittsburgh.

These proceedings were commenced by a Complaint of the City of Pittsburgh, Pennsylvania, filed with the Federal Power Commission on March 17, 1945, alleging that the rates then charged by Kentucky to Pittsburgh, and that the rates then charged by Pittsburgh to Equitable for distribution in the City of Pittsburgh, Pennsylvania, were unjust and unreasonable (Docket No. G-627). The Commission then instituted its own investigation, (Docket No. G-635) consolidated the two proceedings, and hearings thereon began on June 11, 1945.

All of these proceedings have been concluded, with the exception of the proceeding involving the rates charged by Kentucky to Pittsburgh and to Louisville, which is the subject of this appeal.

In the proceedings before the Commission, all jurisdictional questions were waived by the Respondents and it was agreed that if any reduction in rates of Kentucky was found to be necessary, such reduction should be allocated three-fourths to Pittsburgh and one-fourth to Louisville.

On October 8, 1948 the Federal Power Commission by a majority of three to two entered its Order and Opinion No. 168 (App. 18) holding that the rates of Kentucky were excessive in the amount of \$571,284, resulting in a reduction to Louisville of \$142,821 and to Pittsburgh of \$428,463. These reductions were based on the year 1945 as the test year.

The Petition of Kentucky for rehearing and for leave to adduce additional evidence and for stay of Order was filed with the Commission on October 29, 1948

(App. 60-68). Together with said Petition, there was filed certain data, (App. 1372-1399) hereinafter referred to as "unsworn data", which disclosed probable operating results of Kentucky for the year 1948 based upon nine months actual operations and three months estimated. It was contended "*inter alia*" that the year 1948 was a better test year than 1945, and that much of the data relating to 1945 was now obsolete.

On November 26, 1948, the Commission entered its Order and Opinion No. 168-A (App. 72-81) granting in part and denying in part the rehearing. In consideration of the "unsworn data", Order No. 168 was modified and the rate reduction was tentatively limited to \$376,515, with the provision that the difference, namely, \$194,769, was to be held by Kentucky to await the final Order. Additional testimony was taken from February 14 to February 18, 1949 with respect to the items on which rehearing was granted.

On June 20, 1949, the Commission entered its final Opinion and Order No. 168-B (App. 85-110). Although the Commission without expressly so stating froze the depletion rate at the 1945 level, it in practical effect adopted the year 1948 as the test year, and the original Order of October 8, 1948, No. 168, was modified so that the reduction was finally determined in the amount of \$422,406, and was allocated to Pittsburgh and Louisville on the basis of 75-25, respectively. On July 15, 1949, the Petition of Kentucky was filed with the Commission for rehearing on Order dated June 20, 1949 (App. 111-119), in which objection was made to Orders and Opinions Nos. 168-B, 168-A and 168, and objections made in the previous Petition for rehearing were renewed and restated. The Commission failed to act upon the said Petition within thirty days. The rehearing was, there-

fore, denied, and this Petition to review and set aside Orders of the Federal Power Commission, issued on October 8, 1948, November 26, 1948 and June 20, 1949, was filed in this Court on August 18, 1949, and within sixty days after the final Order of the Commission issued June 20, 1949. The issues involved are identified in the "Summary of Argument", and "Statement of Points" to which reference is herein made.

III. STATEMENT OF POINTS

Petitioner relies upon the following points. After each point reference is made to a corresponding point in the Petition for Review.

1. The Commission's allowance for annual depletion for the test year 1948 was insufficient and inadequate (points 22, 23, 24 (App. 12)).

2. The Commission has unreasonably reduced allowances for operating expenses in the test year 1948 in the total amount of \$48,546 (point 25 (App. 12)), and in reducing the allowance for materials and supplies by the amount of \$263,879 (point 27 (App. 13)).

3. The Commission was in error in allowing only a 6% return (point 30 (App. 13)).

4. The Commission was in error in giving sole consideration to original cost, and in refusing to give any consideration to any element of present value, including fair field price of gas (point 28 (App. 13)), and in refusing to receive or consider evidence bearing upon present reproduction cost or the fair value of the properties of the Petitioner, and in refusing to give any consideration to or make any allowance for the changed buying power of money (point 29 (App. 13)).

IV. SUMMARY OF ARGUMENT

The Commission is required to allow Respondent a sufficient sum to cover its expenses, including an adequate depletion allowance. This it did not do.

The Commission is obliged both to follow a method and to make findings which will enable this Court to ascertain whether or not the depletion rate allowed is adequate. This it did not do.

The Commission has the burden of proof where, as here, it orders a reduction in rates. This burden the Commission has not met.

1. The depletion allowance for the test year 1948 is inadequate in three respects (a), (b) and (c):

(a) The Commission staff determined the depletion rate for the first test year 1945 by a method specifically approved and adopted by the Commission. For the second test year 1948 the Commission adopted the rate determined by the staff for the year 1945, but rejected the staff's method which would have resulted in a higher depletion rate for the test year 1948. This treatment by the Commission by a bare majority, with two Commissioners dissenting, resulted in the reduction of the depletion allowance for 1948 in the sum of \$139,396.

The majority reached this conclusion because of their assertion, unsupported by evidence, that estimates of recoverable gas were unreasonably low. It refused on rehearing to hear any evidence on the subject of depletion, present, past or future.

The method for determining annual depletion presented by the staff would not only result in the rate

changing from year to year, but would result in a higher one.

The majority of the Commission in a vague way revealed in Opinion 168-A (App. 71-81) that they had reversed their previous Opinion 168 on this point, but did not so state. Acting on this Opinion the Examiner refused to receive evidence of the experienced results to show the proper depletion rate under the staff's method for the years 1946, 1947 and 1948.

The statement in Opinion 168-B (App. 95), "with depreciation and depletion expense calculated in accordance with the method and the rates employed in our Orders of September 2, 1948 and November 24, 1948", is only correct insofar as it refers to the rate for 1945, which was frozen. The statement that it is in accordance with the "method" is wholly incorrect in that the "method" would inevitably produce a higher rate when applied to the facts of 1948.

The staff of the Commission and witnesses for Kentucky reached complete agreement on the estimate of the gas reserves for the years 1944 and 1945, the last year the staff was permitted to make an estimate.

The Commission erred in failing to consistently apply the principle which it purported to follow. It purported to follow the staff's method and give an allowance for depletion which would reimburse the Company for its entire investment over the period of their service lives. It failed to give such an allowance.

(b) The Commission refused to give any consideration to the appropriate depletion rate for a future year when the tariffs fixed by the Commission would be in effect, such, for instance, as the appropriate depletion rate for the year 1950.

(c) The Commission included the estimates of reserves from the future deepening of shallow wells but refused to allow for the cost of such deepening, thereby reducing the proper allowance for depletion at this time.

2. The Commission in effect substituted the year 1948 as the test year for the year 1945, but departed from its previous approach in two particulars, in addition to the one just mentioned in the annual depletion allowance, namely—

(a) It eliminated certain so-called non-recurring items in *toto*. It did not amortize them over a period of years nor did it make adequate provision for such or similar items, notwithstanding that such items do re-occur.

(b) The Commission refused to reapply its formula of 1945 to determine the proper allowance for materials and supplies. It reduced the monthly averages for materials and supplies by assuming without supporting evidence that the quantities in 1945 were adequate for 1948, making allowance only for the increased costs, thereby reducing the annual monthly balances for materials and supplies in 1948 in the amount of \$263,879, which resulted in reducing the return at 6% in the amount of \$15,833.

3. The Commission allowed a return to Kentucky as a producing natural gas company of only 6%, departing from its earlier rulings of allowing 6½%, notwithstanding the special facts in this case, among which was the fact that Kentucky held approximately 80% of its natural gas holdings in fee, most of which it had purchased at a substantial price prior to 1930, and to the further fact that Petitioner's witness, Coffman, had

shown that a fair return for Kentucky should be $7\frac{1}{2}\%$ based on the investor's appraisal as determined by the earnings-price ratios of stocks and the return which investors could earn in the securities of natural gas companies.

4. The Commission gave sole and single consideration to original cost. It assumed that this consideration inevitably resulted in a "just and reasonable end result" without giving any consideration whatsoever to value or to present value even under the special facts in this case. A majority of the Commission refused to give any consideration to such items as present fair field price of gas, present value of natural gas freeholds and leaseholds as compared with original cost, being over four times original cost, present reproduction costs, or to changes in the buying power of money, particularly as related to the fact that the present worth of money as a rate of return was substantially less than the worth of money at the time at which most of the freeholds and leaseholds were obtained prior to 1930.

V. ARGUMENT

PART I

Annual Depletion Allowance.

Petitioner contends that the Commission's allowance for annual depletion for the test year 1948 was insufficient for the following reasons:

A. The Commission used the staff's rate for depletion for the year 1945, as applicable to the year 1948, and in so doing, abandoned and set aside the staff's method for determining annual depletion. It had previously specifically approved the staff's method. The staff's method applied to 1948 would substantially increase the depletion allowance.

B. The Commission refused to consider or allow the higher depletion rates applicable to future years when the new tariffs would be in effect; the years 1949, 1950 and 1951, for instance.

C. The Commission included the additional gas which might result from the possible future deepening of certain existing shallow wells, but refused to allow for the cost of deepening such wells.

The above conclusions were adopted by a bare majority of three. There were two dissents.

A. The Commission Used the Staff's Rate for Depletion for the Year 1945, as Applicable to the Year 1948, and in so Doing Abandoned and Set Aside the Staff's Method for Determining Annual Depletion. It Had Previously Specifically Approved the Staff's Method. The Staff's Method Applied to 1948 Would Substantially Increase the Depletion Allowance.

If the Commission had consistently followed the principles and approaches which had been used by its staff and which it had specifically approved, the additional allowance for depletion in the test year 1948 would have been the sum of \$139,396, as will appear from Exhibit No. 235 (App. 1335) and testimony of Mr. Ruemmele (App. 760).

The Commission in its Opinion No. 168, issued October 8, 1948 (App. 18), adopted the staff's method in determining the annual depletion allowance, and expressly approved it. The Commission said:

"THE METHOD EMPLOYED BY THE STAFF IN THIS PROCEEDING FOR THE DETERMINATION OF THE PROPER RATE OF DEPLETION AND THE APPROPRIATE RESERVE REQUIREMENT FOR DEPLETION IS THE SAME AS THAT HERETOFORE USED AND APPLIED IN ALL SIMILAR CASES OF THIS KIND COMING BEFORE THE COMMISSION, AND AS SO CALCULATED AND DETERMINED, THE ANNUAL ALLOWANCE FOR DEPLETION WILL REIMBURSE THE COMPANY FOR ITS ENTIRE INVESTMENT IN THE RELATED PROPERTIES OVER THE SERVICE LIFE THEREOF." (App. 34)

Obviously if the method employed by the staff results in a higher depletion rate for 1948 than for 1945, as is really not in dispute, then the smaller annual allowance for depletion now fixed by the Commission will not

reimburse the Company for its entire investment in the related properties over the service life thereof.

The Commission states its final conclusion:

"Consequently, we find that the rates of depreciation and the allowances for depletion proposed by the Staff are adequate for the purpose of determining a reasonable allowance for depletion expense and a reasonable depletion reserve requirement", (App. 37)

It obviously departs from its own conclusion when it reduced the allowance for 1948 by \$139,396 below that reached on the application of the staff's method to the experienced 1948 figures.

For a better understanding of this matter, it will be necessary to delve into the exhibits and testimony of the members of the staff of the Commission on this subject.

We can now ignore the contentions of Kentucky before the Commission for a greater allowance than that resulting from the application of the staff's method, because they are not pressed here. This Court therefore has the clear issue of the change of position of the majority of the Commission, and their departure from the staff's method, without any evidence to define or even support such a conclusion.

We, therefore, have a clear and definite issue. The Commission in its Opinion No. 168 (App. 18) adopted the staff's method and conclusions. In its Opinions Nos. 168-A (App. 72) and 168-B (App. 85), it refused to follow the staff's method which would result in a higher depletion rate for 1948, and arbitrarily froze the 1945 rate, and this notwithstanding it was admitted both by the Commission's staff and the witnesses for Kentucky

that the depletion allowance for 1948 on the staff's method would be substantially higher. No additional testimony was taken or permitted on the subject of the annual depletion rate for 1948, and Kentucky's exhibits on this subject were rejected.

Reference is first made to the complete coverage of this subject by Kentucky's witness, Kuhn, in his testimony (App. 353) and in his Exhibit No. 95, (App. 937-949) and the charts contained therein for the purpose of showing how fully and completely this subject (the increasing cost of gas) was covered by a witness for Kentucky.

All the witnesses agree that the depletion rate will change from year to year, and that as the lower cost gas of the past is used up and more costly gas is being produced, the annual depletion rate will increase from year to year. Therefore, the freezing of the depletion rate for 1948 at the 1945 level does not make any allowance for the actual experienced increasing cost of developing gas.

The Commission presented its study on the subject of annual and accrued depreciation and depletion through its witness, Mr. Luttring, in his Exhibit No. 191 (App. 1119-1233) (for the year 1944), and Exhibit No. 192 (App. 1235-1281) (for the year 1945) and introduced certain explanatory statements found in Exhibit No. 191, as follows: (App. 1121, 1124)

"Accrued depreciation and depletion determined and recommended herein by the Commission's staff is the result of applying, * * * in the case of depletion rates derived from gas produced, to the company's actual investment in the plant in accordance with the following principles and procedures:

Depletion Rates: Commission engineers estimated the gas reserves underlying leaseholds, gas rights and gas wells. The rate of depletion is the ratio of annual production to the total recoverable gas reserves each year. Annual rates of depletion arrived at by this method are shown in Schedules 6, 7, and 8 and were applied to the following accounts:

Acct. No.	Title
330.2	Natural Gas Producing Leaseholds
330.3	Natural Gas Rights
332.1	Producing Gas Wells—Well Construction Cost of Abandoning Wells

and further—

“Annual amounts of depletion are based on rates, of depletion explained above applied to the undepleted investment, plant cost less reserve.”

Kentucky's Investment Rate Base.

The Commission in Opinion No. 168 (App. 38 and 39), determines the total investment rate base for Kentucky as of December 31, 1945 to be \$13,643,999. This figure is obtained by deducting from gas plant the estimates of the staff for the proper allowances for existing depreciation and depletion. This figure of \$13,643,999 is derived from Commission staff witness Luttring's Exhibit No. 202, (App. 1287) and reflects the staff's method and basis for determining the investment rate base.

The Commission adopted and approved this investment rate base, saying: (App. 38, 39)

“Employing the figures agreed upon and as heretofore determined, we find that the investment rate base of each of the Respondents as of December 31, 1945, is the amount of \$13,643,999 for the Kentucky Company.”

The Commission also expressly approved the rates of depreciation and allowances "for depletion proposed by the staff for depletion expense and a reasonable depletion reserve requirement", (App. 37). One would therefore assume that not only was the investment rate base question settled, *but also the methods and principles by which it was determined.*

This treatment is precisely in accord with many prior decisions of the Federal Power Commission. Note the following quite recent landmark cases :

Re *United Fuel Gas Company*, 67 PUR (NS)
161, at 167-175

Re *Cities Service Gas Company*, 50 PUR (NS)
65, at 80, 87, 88

Re *Hope Natural Gas Company* 44 PUR (NS)
1, at 18

Re *Canadian River Gas Company*, 43 PUR (NS)
205, at 218, 219

The following quotations from the three most recent cases set forth the reasons and the basis for this treatment:

In the case of *United Fuel Gas Company*, *supra*, the Commission stated:
(pp. 168 and 169)

"Where, prior to regulation a natural gas company accumulated large excesses in its reserves, we have considered it reasonable to deduct the lower reserve requirement. * * * Under these circumstances, in order to obtain the proper starting point for the future, we believe it reasonable to use the reserve requirements as the measure of accrued depreciation and depletion instead of the higher book figures."

In the case of *Cities Service Gas Company*, *supra*, the Commission stated:

(p. 80)

"The depreciation rates recommended by the staff in computing both the annual depreciation expense and the reserve requirement (accrued depreciation) were derived from the average service lives of the various classes of property owned by the Company. * * * The method used by the staff conforms to our previous decisions. Under that method the sum required annually to reimburse the company for the cost of property consumed in whole or in part in rendering service is determined and included in operating expenses, with the result that the company is assured of being fully reimbursed for its capital investment by the end of the life of the property."

In the case of *Hope Natural Gas Company, supra*, the Commission stated:

(pp. 18 and 19)

"This company has actually accumulated an excessive reserve. We are confronted, therefore, with the question as to whether that excessive reserve, or the reserve requirement (actual existing depreciation and depletion) should be deducted in determining the rate base. We have formerly indicated that public utilities ought to set up proper depreciation (and depletion) expense and that the resulting reserve should be deducted from the gross cost in the rate base determination. We reiterate that view.

We believe, however, that under such circumstances as exist in this case, where a large part of the company's business is brought under regulation for the first time and where incorrect depreciation and depletion practices have prevailed, the best procedure is to deduct the reserve requirement in computing the rate base. * * * *Use of the reserve requirement in this case will produce a proper starting figure so that the book reserve can be deducted hereafter as the proper measure of the actual depreciation and depletion. This treatment will then be consistent with the view that the book reserve is the proper*

deduction from the gross cost in determining the rate base." (Emphasis supplied)

Method of Determining Annual Depletion.

The method or formula which the staff uses in determining the annual depletion allowance for the depletable items for each year—is to divide the dollars which have been invested in depletable plant, and not heretofore depleted—by the estimated developed gas reserves less withdrawals related thereto—thereby deriving the annual depletion rate in cents per MCF, and then to determine the annual depletion allowance for each year by multiplying the gas produced in each given year by the appropriate cents per MCF. This is obviously the right formula which, as the Commission says, is not only approved in this case, but is the one that has been "applied in all similar cases of this kind coming before the Commission". Why the Commission should suddenly depart from this formula is difficult to understand, and no explanation is offered except by one member of the majority, who only confuses the real issue by referring to the unrelated problems and difficulties of making estimates of reserves, and to the historical difficulties and conservative policy of the Company in making such estimates in the past.

The accuracy of the estimates of the gas reserves for 1944 and 1945 is not in controversy. Commission witness Mr. Walters, who made the estimates for the Commission, agreed 100% with the overall conclusions reached by the witnesses for Kentucky. See his Exhibits Nos. 181 (App. 973-1043), 182 (App. 1045-1077) and 183 (App. 1079-1086).

In his Exhibit No. 181, dealing with the estimated gas reserves as of December 31, 1944, he says:

"Method of Estimating Gas Reserves — Individual well graphs of rock pressure versus cumulative production were used to estimate the remaining recoverable gas reserves. On certain wells there is insufficient history of production and rock pressure decline. In those cases the estimate is a judgment figure based on data of other wells of similar initial open flow and initial rock pressure and produced from the same horizon. Included in the judgment type of reserve estimate were those wells which were not connected (n. c.) to a pipe line system on December 31, 1944 either because of their recent completion date or because of their isolated location. A few wells having erratic rock pressure data, were estimated by rate of delivery decline.

The Commission's staff estimated reserves for 10% of the Company's wells by selecting at random new wells, old wells, wells located in each operating district, and wells producing from the various horizons. This group of wells was considered to be a representative cross-section of all of the Company's wells. These estimates were then compared with the Company's estimates. Although the estimates on individual wells were not always in agreement, the totals of the two estimates were surprisingly close. *The staff has therefore accepted the Company's estimate of 169,422,000 MCF as the reserves to be recovered from existing wells.*" (App. 974-5) (Emphasis supplied)

An examination of Exhibit No. 181 and the detail shown in the study of the individual wells reveals the basis for each reserve estimate. It shows a preponderance of wells where curves had been developed, since rock pressures, production and other historical data were available. It also shows those wells where such information is not yet available and a judgment factor had to be applied.

It does not seem necessary to pursue this subject further because there is no controversy concerning the reasonable accuracy of the estimates made by the witnesses for the Kentucky Company. The staff has accepted these estimates as the best possible estimates and has put their stamp of approval thereon one hundred percent. In reality the question of the accuracy of the estimates is not involved in the issue and is really beside the point.

No estimate of gas reserves for 1948 was made by the staff because the Commission froze the 1945 depletion rate, and the Examiner felt compelled to rule out the issue, and denied Kentucky the right to introduce estimates.

Mr. Ruemmele for Kentucky in the first hearing prepared Exhibits Nos. 204 (App. 1291-1303) and 206 (App. 1317-1329) showing the appropriate annual allowances for depletion for the years 1946 to 1950, inclusive, by using the staff's method, submitted the same to the staff, and was advised that he had correctly applied the formula (App. 714). We may, therefore, assume that the figures presented by Kentucky's witness Ruemmele for the years subsequent to 1945 at the second hearing are correct and are the same figures that would have been presented by the Commission's staff had they prepared same.

Let us now examine the opinions of the majority and of the two dissenting Commissioners, on the question of the depletion rate, i.e., the one properly applicable to each year.

There was no controversy as to the rate properly applicable to the year 1945, when Opinion No. 168, was

handed down on October 8, 1948, because the Commission then adopted and applied the staff's determination for the allowance for depletion for the year 1945, the test year. The question of the use of a higher rate than the 1945 rate, namely that for a future year (1948 for instance) then pressed, was another issue. Nor was the present controversy known to exist when the Petition for Rehearing for Kentucky was filed with the Commission on October 29, 1948. In connection with the Petition for Rehearing, certain data pertaining to 1948 was informally submitted to the Commission, hereafter referred to as "unsworn data", which was filed to support the contention of Kentucky that much of the data and material relating to 1945 as the test year had become obsolete, and that data and material pertaining to 1948 would show that the reduction which had been ordered of \$571,284 in the rates of the Kentucky Company was excessive. The data submitted showed the operating results for the year 1948 based on nine months actual operation and three months estimated, and it was contended that 1948 was "a far better and more accurate basis for the determination of cost of service for the present and immediate future than the year 1945." In submitting this data, the allowance for depletion for the year 1948 was set up on the basis of the method used by the staff of the Commission as related to the facts then determined for the year 1948, and showed the allowance for depletion for the year 1948 to be \$1,150,613, Exhibit No. 235 (App. 1335). Without any discussion of the matter or any revelation of what the Commission was really doing, the amount was reduced by the sum of \$133,523 to the figure of \$1,017,090. See Order issued November 26, 1948, (App. 79) which carries the vague and ambiguous statement:

"Adjustment by Commission to conform to Opinion No. 168 and Order of September 2, 1948—\$133,523."

In the absence of any further clarification of what the Commission had done, it was impossible for counsel for Kentucky to understand the plan behind the adjustment until members of the staff of Kentucky at Ashland, Kentucky, made the necessary calculations, and reached the conclusion from the figures that the Commission was freezing the 1945 rate, and making it applicable to 1948, and was refusing to give effect to the mathematical conclusions which would be derived from an application of the staff's method to the actual experienced results of 1946, 1947 and 1948.

A limited rehearing was granted and additional testimony was taken from February 14 to February 18, 1949, inclusive. The Commission handed down its Opinion No. 168-B, (App. 85) on June 20, 1949, and therein for the first time clearly revealed that it had frozen the depletion rate of 1945, and made it applicable to 1948, and presumably also for future years.

The majority opinion offers no explanation or reason for the departure from the staff's method in determining annual depletion, and disposes of the issue with what we regard as an obviously incorrect statement, namely, "with depreciation and depletion expense calculated in accordance with the methods and the rates employed in our Orders of September 2, 1948 and November 24, 1948." The Commission is correct insofar as it refers to the fact that it has applied the 1945 rate to 1948. The Commission is clearly in error insofar as it refers to the "method", which if accurately applied to 1948 would increase the depletion allowance in the amount of \$139,396.

If it were not for the dissenting opinion of Chairman Smith and the concurring opinion of Commissioner Buchanan, no light would have been thrown upon this conduct on the part of the Commission, which really repudiates the position taken by its own staff and the position which it had unanimously adopted and applied in Opinion No. 168 (App. 18).

The dissenting opinion of Chairman Smith, (App. 103, 104), is as follows:

"Although 1948 is now adopted as the test year for purposes of prospective rate-making in respect of other items, it appears that appropriate consideration is not given, in the computation of depletion according to the principles approved by the Commission in Opinion No. 168, to the higher recovery costs experienced by the Company from 1945 to 1948, as indicated by Exhibit 235, and in reasonable prospect from that year on."

As we have pointed out and as Exhibit No. 235 (App. 1335) shows, the difference in the depletion rate for 1948 (as compared with the frozen rate for 1945) as first calculated in the "unsworn data" would show a difference of \$133,523—based on nine months actual operation and three months estimated. The testimony later introduced of the actual operations of 1948 showed that the difference was the figure of \$139,396.

Commissioner Buchanan then files a concurring opinion (App. 109) apparently for the purpose of attempting to answer Mr. Smith's dissenting opinion. Commissioner Smith did not say—as Commissioner Buchanan tried to have him say—that Exhibit No. 235 indicated both higher recovery costs for 1948, *and also for the future*. Commissioner Smith said that higher recovery costs were "in reasonable prospect from that

year on", as all the evidence clearly established, but not Exhibit No. 235.

Commissioner Buchanan then proceeds to make the startling and wholly erroneous statement that the Commission's treatment of depletion now is not inconsistent with the principles followed in Opinion No. 168; and referring again to Commissioner Smith's statement to the contrary says:

"A simple recital of the facts will show there is no basis for such statement". (App. 109)

Perhaps it should be noted that Commissioner Buchanan did not become a member of the Commission until after the original hearings were concluded and the case had been briefed and argued. He then adds arguendo:

"In the original proceedings culminating in Opinion No. 168, Kentucky West Virginia Gas Company introduced evidence to support its contentions that the annual depletion rate for the years beyond 1945 would be a constantly increasing rate. *The record also contained evidence by the Staff which indicated an increasing annual depletion rate but lower than the rate shown in the Company's evidence.* But these projections of the annual depletion rate for the future were based on unreasonably low estimates of recoverable gas. A proper appraisal of the recoverable gas indicated that the annual depletion rate experienced in 1945 would be a reasonable rate for some time in the future. Accordingly, we prescribed the annual depletion rate experienced in 1945 for test year purposes (see Opinion No. 168, pages 21-23)." (Emphasis supplied)

Commissioner Buchanan's statement concedes that both the staff and the Company realize that there will be an increasing annual depletion allowance arising from the application of the method of the staff to the changing facts from year to year. How he can possibly say this in one breath and repudiate the effect of it in

another, we are at a loss to understand. The difficulties which are inherent in arriving at final estimates of reserves of recoverable gas are fully recognized, but the difficulties have nothing whatever to do with the principle that we are considering here and which the opinion of the majority has set aside. All depletion rates must incorporate estimates of reserves. Furthermore, as we have pointed out, the staff of the Commission independently made a thorough study of the subject, and were in complete accord with the conclusions reached by the witnesses for Kentucky. There is absolutely no foundation in the record for the statement that estimates for 1944 and 1945 were unreasonably low. Quite the contrary is true, as they were expressly approved and adopted by the Commission's own staff after an independent study, as Exhibits Nos. 181, 182 and 183 will show with the testimony of Commission's witness Walters, (App. 650-3). As to the estimates for future years, there is no evidence in the record, except that offered by Kentucky's witnesses, and therefore no evidence to bring the estimates in question, or to support Commissioner Buchanan's statement. The Commission has the burden of proof here.

Is it not demonstrated beyond question that the depletion rate will increase from year to year by reason of the fact that the more recent wells are much more costly to drill, and the recovery from these wells is estimated to be less than from the earlier wells? That there can be no doubt about this fact is clearly established in Petitioner's rejected Exhibit No. 237, (App. 1337). This shows the number of wells drilled in the years 1942 to 1948, inclusive, the average developed reserves per well in each of these years, and in the next to the last column shows the average cost per well of

the items considered depletable by the Commission, showing a rising cost from \$11,235 per well in 1942 to \$16,514 in 1948. It also shows an average cost per MCF of reserves developed, running from 3.241¢ per MCF in 1942 to 6.589¢ per MCF in 1948, or over double the cost per MCF in 1948 as compared with 1942.

The figures for the years 1944 and 1945 were developed by Commission witness Luttring, Exhibit No. 191, showing a rate of 2.88¢ per MCF for 1944, and Exhibit No. 192 for 1945 showing a rate of 3.16¢ per MCF, or an increase of .28¢ per MCF in 1945 over 1944.

The Commission used the 1945 rate of 3.16¢ per MCF for 1948, when it should have used the figure of 3.6453¢, Exhibit 238 (App. 1339) which was the appropriate rate for 1948 on the staff's method. All of these figures, also shown in graph and curve form in Exhibit No. 240 (App. 1351), clearly demonstrate the way in which the depletion rate is rising in recent years. The figures are derived by the application of the staff's method to the relevant figures for each of the years from 1940 to 1948, which show an increase from 2.10¢ per MCF in 1940 to 3.64¢ in 1948. Other exhibits show how much more the rate will rise in future years, particularly the rejected Exhibit No. 243 (App. 1367).

Another matter should be called to the Court's attention, namely, the variation in treatment by the Commission of the cost of drilling the wells and the cost of equipping the wells. Well equipment,—because the staff contends it may be used again,—is depreciated, whereas the cost of drilling is depleted. The Commission allows for the increasing costs of materials in the well in 1946, 1947 and 1948, since it applies straight line depreciation

to the rising cost of the equipment, but it refuses to recognize the increasing costs in drilling the same wells because it freezes the depletion allowance for 1948 against 1945 costs. The treatment is obviously inconsistent.

The record is clear on the point that the application of the staff's method and formula applied from year to year will change with the related facts of each year, and also will result in a higher depletion rate for 1948 than for 1945. Mr. Smith is right in stating that the Commission has departed from the methods and principles which it had approved. Mr. Buchanan is clearly wrong and is really only confusing the issue by discussing irrelevant and unrelated matters, and upon assumptions of facts not borne out by the record.

The Commission has therefore clearly acted arbitrarily, without a scintilla of evidence in the record to support its conclusion that the 1945 depletion rate is the appropriate rate for 1948, or for any succeeding year. There is no magic in the 1945 rate for depletion, and nothing in the record to support the idea that it could possibly be the applicable rate for 1948. The action of the Commission in rejecting the method of the staff which it specifically approved is, therefore, wholly arbitrary.

The decision of this Court in the case of *Mississippi River Fuel Corporation v. Federal Power Commission*, 82 App. D. C. 208, (1947) 163 Fed. 2d 433, 69 PUR (NS) 129, pages 147-153, is precisely in point and we believe rules the determination of this question. At page 148, the Court stated:

"In the present case the Commission has rejected the depreciation allocation study of its staff. We

are not supplied with any clear idea as to why or how the Commission, rejecting the expert evidence before it, simply divided the whole depreciation charge into halves and allocated one half to demand and the other half to commodity. No finding of fact supports the conclusion. We are supplied with no data with which to test its validity.

* * * * *

"Depreciation is an important item of cost, and an allowance of a correct amount is a right of the Company."

(p. 150)

"It has also held that the grounds upon which an administrative order must be judged are those upon which the record discloses that the action was based, and that where the decision of a Commission is explicitly based upon the applicability of certain principles, its validity must likewise be judged on that basis."

On Petition for Rehearing, the Court reaffirmed its previous decision and returned the case to the Commission for further consideration—as it should do in this case—saying:

(p. 151)

"The character of a rate—fair, reasonable and non-confiscatory as our law knows it, is not an abstract economic concept of the proper price to be paid by consumers for a commodity or service. Our law has never provided that either a company, a commission, or a court can fix a price for a utility commodity or service by an abstract observation or by a comparative evaluation of current prices for other commodities or services, or by any such process. The character of the rate has always been determined, in our law, by its relationship to the sum of a number of components. Those components, principally, are the expenses of the operation, an allowance for depreciation or depletion, and a proper 'return' to the Company. If the rate yields no more than the sum of these items, it is fair and reasonable."

(p. 152)

"It follows from the foregoing that a court can review the fairness, reasonableness and non-confiscatory character of a rate only by reviewing the propriety of the elements of which the rate was composed. No other way is known to our law, or ever was followed by any authority so far as we know. No standard is available for use in any other process of review."

To the same effect, see *Colorado-Wyoming Gas Co. v. Federal Power Commission*, 65 Supreme Ct. 850, 58 PUR (NS) 94, 98. The Commission finding as to the Company's "system peak day" was rejected as inadequate (316 U.S. at 631):

"Here as in the cases of Canadian and Colorado Interstate the findings of the Commission leave much to be desired. The findings are general and incorporate by reference the staff exhibits, on which reliance is put for the subsidiary findings. But in this case there are added difficulties. *The staff used one system, the Commission another.*" (Emphasis supplied)

There was a dispute in the record as to what the amount of "direct sales" was on the peak day. The Commission used the figure of 522 MCF rather than 1077 MCF. The Court said (324 U.S. at 633):

"We do not know why the lower figure was rejected. There are no findings to guide us."

Our position with respect to the inadequacy of the depletion allowance for 1948 may be summarized as follows:

1. Kentucky is legally entitled to have allowed as part of its operating expenses a reasonable and proper depletion allowance for the year 1948.

Columbus Gas and Fuel Company v. Public Utilities Commission, 292 U.S. 398, 4 P. U. R. N. S. 152, 157,

"To withhold from a public utility the privilege of including a depletion allowance among its operating expenses, while confining it to a return of $6\frac{1}{2}\%$ upon the value of its wasting assets, is to take its property away from it without due process of law, at least where the waste is inevitable and rapid."

Mississippi River Fuel Corporation v. Federal Power Commission, supra,

"Depreciation is an important item of cost and an allowance of a correct amount is a right of the Company". (Emphasis supplied)

2. The Commission is under the duty of making specific and adequate findings to enable this Court to know that Kentucky has actually been allowed a reasonable and proper depletion allowance. No such finding exists in this case. Quite obviously the allowance is inadequate, and is not based upon any definite or probative evidence.

3. Kentucky is denied the essentials of a full and fair trial and is thereby deprived of its legal rights without due process. The Commission in effect and without definitely so stating reversed its previous determination with respect to the annual depletion rate and then denied Kentucky the right to introduce evidence to show that the assumptions and conclusions reached by the Commission were in error:

Morgan v. United States, 58 S. Ct. 773, 23 PUR (NS) 339, 343, 344, 345-346.

On page 343 the Court said:

"The right to a hearing embraces not only the right to present evidence but also a reasonable opportunity to know the claims of the opposing party and to meet them. The right to submit argument implies that opportunity; otherwise the right may be but a barren one. Those who are brought into

contest with the Government in a quasi judicial procedure aimed at the control of their activities are entitled to be fairly advised of what the Government proposes and to be heard upon its proposals before it issues its final command."

On page 344 the Court said:

"The requirements of fairness are not exhausted in the taking or consideration of evidence but extend to the concluding parts of the procedure as well as to the beginning and intermediate steps."

On page 345-346 the Court said:

"The maintenance of proper standards on the part of administrative agencies in the performance of their quasi judicial functions is of the highest importance and in no way cripples or embarrasses the exercise of their appropriate authority. On the contrary, it is in their manifest interest for, as we said at the outset, if these multiplying agencies deemed to be necessary in our complex society are to serve the purposes for which they are created and endowed with vast powers, they must accredit themselves by acting in accordance with the cherished judicial tradition embodying the basic concepts of fair play."

4. The formula and methods used by the Commission staff necessarily incorporate the use of the best estimates of reserves at the time that the annual depletion rate is determined. There is not only no evidence in this record to show that the estimates made in 1944 and 1945 were in error, but, on the contrary as pointed out, these estimates were reviewed and approved by the Commission's staff and accepted as the best estimates that could be made at that time.

When we come to the year 1948, Kentucky was denied the right to introduce any evidence on the subject of the annual depletion rate or allowance or to show that the arbitrary and assumed conclusions reached by

the Commission were in error. Obviously no mere assumption of inaccuracy should be allowed to control the answer against the evidence then available in 1948 respecting the natural gas reserves. The evidence had consistently shown that notwithstanding revisions of estimates made from time to time as more definite and complete information became available, the depletion rate would rise from year to year. The fundamental injustice to Kentucky arises from the fact that Kentucky was denied the right to present evidence to disclose the real facts, because the Commission had prejudged the answer on mere assumptions. An increase in the depletion rate having been shown to be inevitable under the facts and under the staff's formula, the right of Kentucky cannot be brushed aside by the mere assumption on the part of the Commission that there might be errors in the estimates, particularly when there is much less reason to assume errors at this time than there was in the earlier period of the development of the properties.

5. The Commission found that the existing rates of Kentucky were excessive and ordered them reduced. It therefore, had the burden of proof to establish the facts to show that the rate was excessive, and it clearly has not met that burden.

B. The Commission Refused to Consider or Allow the Higher Depletion Rates Applicable to Future Years When the New Tariffs Would Be in Effect, the Years 1949, 1950 and 1951 for Instance.

We have consistently taken the position before the Commission that the rate for depletion should look to the future, to the period when the new tariffs will be in effect. Therefore, in considering the year 1948 as the test year, the depletion rate should consider the appropriate rate for the years 1949, 1950, 1951, for which purpose the depletion rate for 1950 would be fairly representative. Rejected Exhibit No. 243 (App. 1367) shows the rates for these years under the Commission staff's formula. We, of course, recognize that studies made for future years are only estimates, but they are made by persons specially informed and trained in this field, and there is nothing in the record to show that they are wrong. Commissioner Buchanan's mere statement does not make them so. For the year 1950, the depletion rate amounts to 4.26¢ per MCF as compared with 3.16¢ found by the Commission's staff for 1945, or an increase of 1.10¢ per MCF. If the 1950 rate of 4.26¢ per MCF is applied to the 28,588,063 MCF production in 1948, it will produce an annual allowance for depletion of \$315,527 above the 1948 allowance made by the Commission, which is at the 1945 rate of 3.16¢ per MCF.

The dissenting opinion of Commissioners Wimberly and Smith in Opinion No. 168 (App. 50), made this criticism of the majority's use of the 1945 rate, when the year 1945 was taken as the test year, saying:

“* * * and failing to make any allowance beyond 1945 for the indicated increasing trend of gas production costs. In this connection the Commission's

conclusion in the recent United Fuel Case seems pertinent:

“* * * It is evident, therefore, that we cannot fix rates for the future upon the basis of the company's actual experience in 1942 and 1943 but, because of the great change which has occurred and is still in process, must consider the latest available facts as well as expectancies of the relatively near future.’”

The concurring opinion of then Chairman Olds in that case, namely, *City of Columbus v. United Fuel Gas Company*, 67 PUR (NS) 161, at 175, should also be noted, which reads as follows:

“The Commission would be blind to its obligations if, in fixing rates for the future, it uses experience in the past which it has every reason to believe will not be repeated. The weight of the evidence—including facts in the certificate cases and contracts which actually have been entered into between respondents and Tennessee Gas and Transmission Company—proves the future will not be the same as the past. We already know the changes which have occurred between the original test years, 1942-1943 and 1945, and the prospective accentuation of those changes. Hence, we would be dealing with fiction if we were to use the experience of 1945, which the dissenting Commissioner advocates, as the sole test of just and reasonable rates for the future.”

The Federal Power Commission has the right and only the right to fix rates for the future. It must, therefore, use the present only insofar as it reasonably measures the future. This principle is universally recognized as the appropriate standard for rate making. Here, however, the majority of the Commission without stating that they had reversed their previous decision with regard to the allowance for depletion, and without stating that they had set aside the method which had

been "heretofore used and applied in all similar cases of this kind coming before the Commission," and without any facts in the record to guide them adopted the rate for depletion which had been determined for the year 1945.

C. The Commission Included the Additional Gas Which Might Result from the Possible Future Deepening of Certain Existing Shallow Wells But Refused to Allow for the Cost of Deepening Such Wells.

The Commission staff and the Commission have included estimates of the future reserves from the possible deepening of certain of the existing shallow wells, and have included these estimates as part of the present reserves without making any allowance for the cost of getting the additional reserves by the deepening of the wells at some later date. This position is questioned in the dissenting opinion of Commissioners Wimberly and Smith in Opinion No. 168 (App. 49, 50), which reads as follows:

"* * * but we are not satisfied that the majority's application of the cost method is entirely proper and consistent: for example, in the case of the Kentucky company, including estimated prospective reserves from future deep drilling of shallow wells but ignoring the estimated additional costs thereof."

This issue was brought into the case by the testimony of staff witness, Walters, in his Exhibit No. 181, page 3 thereof (App. 975), in which he makes the following statement:

"Of the 159 present shallow wells, the Company proposes to deepen 64 of them to the Devonian shale sometime in the future." (In two of which Kentucky owns only a $\frac{1}{2}$ interest)

He then estimates the future recoverable gas from 63 deepened wells to be 12,600,000 MCF, (an average of 200,000 MCF per well) which figure he adds to the Company's previous estimate and likewise the staff's estimate of 169,422,000 MCF as reserves to be recovered from existing wells. He does not deal with the question of the additional cost of deepening these wells, but does include the additional estimate of reserves in the amount of 12,600,000 MCF, thereby increasing the estimated reserves without increasing the cost, and thereby reducing the present annual depletion allowance because of the dilution. This overall result is not advanced by the witness, Mr. Walters, but is arrived at purely on a technical question of accounting, because the cost of the future deepening of the wells cannot be placed on the books until it is actually incurred. Obviously mere accounting has nothing whatever to do with the realities or the equities of the situation, but is a conclusion derived solely because of certain technical rules of accounting. Obviously such treatment will distort the realities of the situation, and will withhold adequate allowances for depletion at this time, only to greatly increase the necessary allowances for depletion in the years ahead when the money will be spent. Since the ultimate drilling to the Devonian shale will involve the added expense of two operations instead of one, too much weight cannot be attached to the contention that the drilling to the shallow sands makes an important contribution toward the cost of the deeper well. It will be time enough to consider the question of the increased reserves when the money is spent to get those reserves; and if there is an actual saving in the cost of later going a shorter distance it will, of course, be reflected in the cost of getting the additional reserves from the deeper

sands or shale. The present reserves derived from the shallow wells are, of course, included in the estimates, as well as the cost of the shallow wells. The whole approach is the result of a mere bookkeeping theory totally unrelated to the facts, to the equities or the realities of the situation.

Why should the question of the cost be separated from the actual securing of the reserves, where it normally belongs? The effect is to reduce the allowance for depletion now and to abnormally increase the allowance in the future when the cost of the deeper drilling is incurred. The treatment of this matter by the Commission is neither realistic, practical or reasonable.

Calculations derived from Exhibits Nos. 204 and 206 show that for the year 1945 this treatment operated to reduce the depletion allowance in the amount of about \$33,000. This amount will slowly decline from year to year.

Summarizing these matters pertaining to the annual allowance for depletion, covered in Part I, the Commission obviously has taken an extremely adverse position against the rights of the Petitioner, even if it has to disagree with the members of its own staff on the important matter of the annual depletion allowance.

PART II.

Part II deals with the treatment by the Commission of two additional matters involved in the consideration of the year 1948 as the test year, namely:

A. Net adjustments amounting to \$48,546 in operating expenses by the elimination *in toto* of three so-called non-recurring items and—

B. A reduction in the allowance for materials and supplies in the amount of \$263,879, which treatment is at odds with the Commission's earlier formula for determining working capital and materials and supplies.

A. Net Adjustments Amounting to \$48,546 in Operating Expenses by the Elimination in Toto of Three So-called Non-recurring Items.

We recognize that the three items involved are in some respects of a non-recurring type, but our primary complaint is that they were eliminated *in toto*. Furthermore no consideration was given to the well-recognized fact that there are always some items of a non-recurring type, (the expenses involved in this appeal for instance) nor was any plan developed to amortize these actual costs and expenditures. The three items were as follows:

- (a) A substantial legal fee for special tax services.
 - (b) Expenses involved in hearings still going on before the Securities and Exchange Commission.
 - (c) Rate expenses involved in this proceeding.
- We shall consider only (a) and (b).

(a) The major item of a legal fee of \$25,321.24 for income tax counsel is undoubtedly substantial and non-recurring in respect to amount, but on the other hand is not non-recurring for that kind of service. It is substantially eliminated, when it would seem that the proper treatment would have been to amortize it over a period of three to five years and also to add something for the expected recurrence of such items. It was pointed out that such expenses do occur from year to year, and that another bill for like services in the amount of \$10,000 would probably be incurred in the near future. We recognize that the elimination of the bill for \$25,321.24 still left a balance of \$12,502.10 for special services, most of which were of a recurring type, but in the light of the legal expenses already incurred for tax services and those just ahead that allowance seems inadequate under all the circumstances.

(b) The elimination *in toto* of the item of \$9,224.67 paid to the Philadelphia Company, the parent company, in connection with the pending proceedings before the Securities and Exchange Commission, at File No. 59-88, under Section 11(b)2, of the Public Utility Holding Company Act, seems totally indefensible. Among the issues specifically raised by the Order of the Securities and Exchange Commission of December 5, 1946 were the following:

- A. Whether the properties of Kentucky West Virginia Gas Company, together with other gas properties in the Philadelphia Company System, constituted a single integrated gas utility system or systems; and
- B. Whether the properties of Kentucky West Virginia Gas Company are retainable under the control of the Philadelphia Company.

The Kentucky West Virginia Gas Company was named as Respondent in all of those Orders and it had its own vital interest in the proceedings.

The Commission eliminated the item *in toto* on the theory that the only company involved in such proceedings was the holding company, an assumption contrary to the facts because the Kentucky Company was also named as one of the Respondents, and it had its own interests involved in trying to hold together a combination of operating companies which definitely accomplished certain useful purposes for the Kentucky Company. The Kentucky Company was a respondent and when attacked it undoubtedly had the right of any respondent to pay its share of the expenses. Its payment to the Philadelphia Company was only its share of the total expenses, allocated to all the respondents. The item is also something more than non-recurring at this time since litigation is still going on and it has been estimated that similar items amounting to approximately \$10,000 a year will be incurred in 1949 and 1950. It should have been allowed in full, or in any event, amortized over a period of three to five years, the same as any litigation expense. If amortized on a three year basis the item would remain in full.

B. A Reduction in the Allowance for Materials and Supplies in the Amount of \$263,879, Which Treatment Is at Odds With the Commission's Earlier Formula for Determining Working Capital and Materials and Supplies.

The average monthly amount for materials and supplies during 1948, Exhibit 152-A (App. 963), show a figure of \$726,901, which the Commission has reduced

by the amount of \$263,879, which means a denial of any return thereon, and which at 6% would amount to \$15,833 annually.

This represents a definite departure from the formula originally used by the Commission in determining working capital which it used and applied in its Opinion 168. The staff of the Commission, through Mr. Lutting, introduced Exhibit No. 194 (App. 1283) for working capital requirements for 1945, and allowed for "Materials and Supplies" (Average monthly balances Per Books During 1945). The item both in 1945 and in 1948 represented the judgment of management as to the proper amount of materials and supplies to be carried both for maintenance and construction work, and also represented the actual money invested by the Company in these items. If it is now denied a return on this item of \$263,879, then no return will be allowed until it becomes part of the rate base because of completed construction or is used in maintenance. In the meantime, the Company is denied all return on its investment, its actual money outlay.

The Commission arrives at its conclusion to reduce the actual investment in materials and supplies during 1948 in the amount of \$263,879 by setting up the quantity of materials and supplies in 1945 as the controlling criterion for the proper quantities in 1948 and allows only for the increases in prices which have taken place between the two periods, which they find to be 26.86%. There is nothing in the record to support the assumed premise that 1945 quantities were actually adequate in 1945, and certainly nothing to support the assumption that they were adequate for 1948. Quite the contrary is the fact as disclosed by the record. Mr. Ruemmele,

(App. 783), pointed out that the conditions in 1945 were affected by the limitations imposed by World War II, which made it difficult to obtain a full and adequate supply of materials and supplies, and that in 1945 the Company was living in a state which might be described as a hand to mouth existence for materials and supplies, and that the Company was in fact merely temporizing with the situation because of the difficulties of getting an adequate amount of materials and supplies. The figures furnished by Company witness Ruemmele were the average of the monthly balances under the formula previously used by the staff and the Commission and these balances reflect the judgment of the managers of the property. There is absolutely nothing in the record to bring that judgment into question or to throw doubt as to the wisdom thereof. The Commission is clearly in error in attempting to hold the Company to the level of materials and supplies in 1945 and to allow only for the 1945 level plus the increased percentage of cost. Denial of the 6% return on the reduction of \$263,879 operates to take away from the Company an annual return at 6% of \$15,833 without any evidence to support it, and sets aside the discretionary rights and judgment of management on the mere and unproven assumption that 1945 quantities were adequate both for 1945 and also for 1948.

In conclusion, with respect to Part II, the Commission has again modified its previous formulas and approaches applied in the first decision in Opinion 168, and has adopted more restrictive and limited allowances.

PART III.**Rate of Return.**

Shortly before the decision of the Commission on September 2, 1948, Opinion 168, the Commission changed its policies in the matter of allowing annual return to natural gas companies and reduced the rate of return from $6\frac{1}{2}\%$ to 6% , so that natural gas companies whose rates have been fixed by the Federal Power Commission since that time are limited to 6% .

First of all we call the Court's attention to the relationship where the rate base is fixed solely on an original cost basis, (as here) and the rate of return is fixed solely on the present cost of money, (as here) and in connection therewith to the changes in the buying power of money over the years. In this case most of the natural gas lands, 80% of which are held in fee, were acquired prior to 1930 with dollars of higher buying power than present dollars. The original cost of 786,914 acres owned in fee and 182,135 acres held under lease, as of December 31, 1944, was \$3,626,649.17, Exhibit 148. (Note) Return is now limited to 6% in dollars at present buying power. To more graphically illustrate the point, let's assume that a dollar invested in 1927 had one hundred cents buying power and that a dollar today has only fifty cents buying power. This would mean that a present return of 6% would give these investors a return of only 3% in terms of the real value of the money which they invested; obviously an inadequate return to any investor, and particularly to an investor in a risky enterprise.

Note: Exhibit 148 not in printed record.

The testimony concerning rate of return was presented in behalf of Petitioner by Paul B. Coffman, President of Standard Research Consultants, and is covered in his voluminous testimony, both in direct and in extensive cross-examination, (App. 300 to 584) (App. 600 to 614) (App. 723 to 752), and two Exhibits, being Exhibits Nos. 84 and 84-A,—submitted by a limited number of copies of original exhibits, by consent of this Court. The testimony in behalf of the Commission was presented by Mr. Dale E. Goubleman, on the staff of the Commission, and also includes his Exhibit No. 180, his presentation consisting largely of the material in that Exhibit. In addition, Dr. Laurence S. Knappan and Mr. Fred Kleinman appeared in behalf of the Office of Price Administration and the City of Pittsburgh. We will consider herein only the testimony and Exhibits of Mr. Coffman and of Mr. Goubleman.

While Mr. Coffman expressed the opinion that the rate of return for Kentucky should be $7\frac{1}{2}\%$, analysis of his testimony shows that it is essentially a conclusion drawn from statistical data, showing the returns which an investor in natural gas securities could earn in the market, and, therefore, could be expected to demand. He obtains all available and useable statistical data relating to natural gas securities in the United States, and then applies this data to obtain the investors' answer, rather than his own personal opinion.

An examination of Exhibit No. 84, and supplemental Exhibit No. 84-A which brought the information down to the later years of 1945 and 1946, will reveal the completeness and exhaustive character of the data and information furnished in these two Exhibits.

The plan of Exhibit No. 84 is to set forth in some thirty-nine charts by means of graphs and curves the detailed information set forth in the second half of the Exhibit in supporting tables. Your attention is particularly called to charts Nos. 17 and 21.

The most interesting feature of chart No. 17 is what it reveals with respect to the investor's appraisal of the respective risks and therefore the required returns on the five types of utilities disclosed in that chart. It will be noted that the investor's appraisal of the over-all capital risks is lowest for water companies, next for electric operating companies, next for manufactured and mixed gas distributing companies, next for natural gas companies excluding pipe line companies, and next for natural gas pipe line companies. It is clearly demonstrated that the over-all return for a natural gas company should be about 2% higher than for electric operating companies based on the investor's appraisal of the overall capital risks.

Chart No. 21 reveals that the earnings-price ratios of natural gas common stocks fluctuate widely and that investors expect higher returns on natural gas companies, than on other utilities, with the exception of natural gas pipe line companies. Kentucky is a producing natural gas company with important transmission lines.

Let us examine Mr. Coffman's method and approach in his own language: (App. 305, 306)

"I have approached the problem of determining a fair rate of return on the subject companies from the investor's point of view. In the final analysis it is the investor who puts up the capital necessary to establish and carry on a business enterprise. Because of this fact, it is the investor who ultimately

prescribes the conditions under which he is willing to part with his capital. As is well known in investment circles, the investor is primarily interested in the security of his capital investment, and in receiving a fair return thereon. It is equally well known that such factors of security or principal and a fair return are directly related to the degree of risk involved. As the risk increases, the investor demands a higher return, and as the risk decreases, the investor is willing to accept a lower return."

"In making any investment, the investor is at all times evaluating the degree of risk and the various types of securities that are available for investment. In applying the principles of investment to a determination of a fair rate of return for the Pittsburgh and West Virginia Gas Company and the Kentucky West Virginia Gas Company, I have attempted to visualize the position of the investor, who contemplated making an investment in these two companies. I was aware that under regulation these companies are entitled to earn a return which should be sufficient to assure confidence in the financial soundness of the utility, to maintain its credit and attract the required capital.

"If this premise was to be maintained, then, it seemed to me that the return allowed must be commensurate with the return that would be demanded by an investor for the particular kind of risk inherent in these two enterprises. The problem, then, as I saw it, resolved itself into making an appraisal of capital risks in the subject companies."

Referring to the completeness of the study, (App. 308) he says:

"The various companies that I used in my analysis in the gas industry were *all* of those companies, including pipe line companies, upon which I could find information to prepare certain ratio computations."

He draws from his chart No. 17 (App. 329) the following conclusions:

"It is evident from this chart that investors recognize that there are varying degrees of risks in the different divisions of the utility industry. In other words, as on the basis of the over-all appraisal, investors consider the risk attached to water companies' and electric operating companies' securities as a group to be considerably less than that for gas companies. Furthermore, on the same basis investors consider the risk attached to the natural gas division, which, unlike other divisions, produces, transports, and distributes a wasting asset, to be greater than that for the manufactured and mixed gas companies."

Also note the following comment on chart No. 21 (App. 332, 333) :

"Turning to chart No. 21, captioned 'Earnings-Price Ratios of Gas Industry Common Stocks,' shows the investors' appraisal of common stocks of the various gas companies that have been studied in the preceding charts. Such appraisal is made on the basis of earnings-price ratios. These ratios are the result of dividing the earnings for each period by the indicated market value of the common stocks for the various companies. * * *

"In the natural gas companies, excluding pipe lines, the earnings-price ratios stood at 9.08 percent in 1944 for 13 companies, as compared with a high of 13.23 percent in 1942 for ten companies, and a low of 6.96 percent in 1936 for ten companies."

Companion chart No. 7, of Exhibit No. 84-A, also calls for comment. Chart No. 7 of Exhibit 84-A, which gives the monthly earnings-price ratios of ten natural gas companies' common stocks, shows the fluctuations over the years 1936 to 1946, inclusive, and shows earnings-price ratios as high as 17.75% and as low as 6.63%, with an average of between 10% and 12%. It is recognized that since 1942 with some fluctuations there has been a marked decline in the earnings-price ratios of natural gas companies' common stocks and that this de-

cline apparently reached a bottom about the middle of 1946, since which time it has trended upward, by the end of 1946 having returned to an earnings-price ratio of 8.14%. A most significant feature of chart No. 7 is what it shows in the way of fluctuations, thereby identifying the uncertainties and the ups and downs of the natural gas business, and, of course, giving no assurance that the favorable position attained in 1946 is any more likely to be permanent than the equally favorable position of the industry in 1936 when earnings-price ratios were about at the same level as in 1946. It would certainly be unfair to regard the earnings-price ratios of 1945 and 1946 as indicative of any future permanent position of the natural gas industry.

Mr. Coffman uses two basic approaches:

- (a) the indicated rates of return based on investor's appraisals of over-all capital risks, and
- (b) indicated rates of return based on an assumed capital structure of 40% debt and 60% common stock

(Chart No. 13 of Exhibit No. 84-A).

A word should also be added with respect to the final determination of rate of return of $7\frac{1}{2}\%$ for Kentucky as determined by a capital structure of 40% debt and 60% common stock. No question has been raised but that this is a reasonable and proper capital structure. Mr. Coffman figured that a return of $3\frac{1}{2}\%$ would be required on the 40% of debt and fully explained,—based on the many charts and statistics which he furnished,—that a $3\frac{1}{2}\%$ return was a fair and reasonable return on that portion of the capital structure which consisted of bonds. Commission witness Goubleman presented data to show that bonds of natural gas companies have

been sold at lower rates and below 3%. This is true in a few instances but there is always a special explanation, and in many cases it has been necessary to refund the bonds from time to time in order to catch the most favorable markets. It can hardly be expected that natural gas companies will refund their bonds frequently in order to catch the most favorable markets. This approach sets up standards of action which are not always available nor always wise. While it is true that the natural gas industry has grown in favor in the financial world in the last ten years, largely because of the developments which have taken place in the large discoveries of gas in the southwestern part of the United States and the improvements made in the transmission of natural gas under high pressures, and while it is true that this has resulted in the ability of a few natural gas companies to sell bonds at remarkably low rates, it has not necessarily had a corresponding effect upon the common stocks of natural gas producing companies in the Appalachian field, such as Kentucky.

We have heretofore pointed out that the returns on the common stocks of natural gas companies over the last eleven years, as shown in chart No. 7 of Exhibit 84-A, have been subject to wide fluctuations, the average running between 10% and 12%. Mr. Coffman points out in his chart No. 13 of Exhibit 84-A that the indicated rates of return based on the investor's over-all appraisal for the years 1940 to 1945 average 8.37% and for 1945, 6.84%; also that the indicated rates of return based on capital structure of 40% debt and 60% common stock for the period of 1940 to 1945 was 8.82% and for 1945, 6.55%. His suggested return, therefore, of 7½% seems fully supported by his testimony and Exhibits and

clearly indicates that a return of 6% is much too low for Kentucky.

Mr. Goubleman does not personally attempt to express an opinion as to the proper rate of return either in his testimony or in his Exhibit No. 180. Most of the statistical data which he presents does not contradict similar data presented by Mr. Coffman, but tends to confirm it.

PART IV.

Consideration of Value as Distinguished from Sole Consideration of Original Cost.

It seems advisable to group points Nos. 28 and 29 in the Petition to Review (App. 13), since they have to do with questions relating to value, present value.

The Commission has refused to consider or give any weight whatsoever to any aspect of the case which deals with the question of value, and has sustained the Examiner in rejecting all offers of proof which bear upon the question of the fair field price of gas in the territory in which the Petitioner operates, in rejecting all evidence bearing upon the present reproduction cost or fair value of the properties of the Petitioner, including the natural gas freeholds and leaseholds, and in rejecting all offers to show the changes in the buying power of money during the life of the enterprise. It cites (App. 29) as full and complete justification for this position the decisions of the United States Supreme Court in the following cases: *Federal Power Commission v. Hope Natural Gas Company*, 320 U. S. 591; *Canadian River Gas Company v. Federal Power Commission*, 324 U. S. 581; *Panhandle Eastern Pipe Line Company v. Federal*

Power Commission, 324 U. S. 635. Let us therefore, examine these cases to see whether or not they fully support this position.

It is true that these cases leave the Commission quite free from the necessity of adopting formulas of rate regulation which incorporate or give consideration to value as distinguished from original cost, and the Commission has apparently construed this to mean that they are free under all conditions to disregard value, without the slightest consideration of the equities or justice of the case or a consideration of the so-called "just and reasonable end result". The Commission has apparently concluded from its brusque setting aside of these contentions in this case that it is under no duty to consider the question of "a just and reasonable end result" and that such a standard is so vague that it affords no opportunity to the Petitioner to have that issue reviewed on appeal.

We believe that there are issues in this case which cannot be so lightly brushed aside, among others, the fact that the Kentucky Company owns natural gas rights in freehold which are today worth more than four times their original cost. We would have proved this to be a fact if we had been permitted to do so. We also offered to prove the fair field price to show that it was considerably higher than the price allowed by the Commission on the sole consideration of original cost. We also offered to show the fluctuations in the buying power of money over the life of the enterprise, and to show that return in the limited buying power of dollars today must consider and reckon with the greater buying power of the dollars invested over the years in order to do justice to the invested dollars and to produce "a just and reason-

able end result". The ownership of a substantial portion of the gas reserves in fee unquestionably gives Kentucky advantages not possessed by natural gas companies which hold most if not all of their natural gas rights under leases calling for annual rentals and royalties. Some \$3,600,000 had been invested on the gamble that the gas which would be produced would justify the risk of the investment and would, if successful, result in the production of gas at lower costs than those companies which followed the usual and general pattern of holding their natural gas rights by lease. No consideration whatever was given any of these contentions by the majority of the Commission.

Two of the Commissioners, however, in their dissenting opinion (App. 50) stated as one of their grounds for dissent that consideration should be given to the fair field price, saying:

"In any event, however, we could not join in the effort of the majority to draw from rejected evidence concerning gas prices in the field conclusions as to what effects might follow from the application of any such standard to the gas production operations of the Kentucky company. There is no proper basis for sound conclusions as to what effect, if any, a reasonable application of such a standard would have on the rates of these companies. We believe that an analysis of such effect should be based upon a fully developed record, rather than relying simply on statements of counsel and offers of proof. We are of the opinion that actual clarifying evidence as to the result of giving some weight to the value of company-produced gas should have been admitted, thus affording all parties and the Commission full opportunity to test, analyze, and consider it in an appropriate manner."

This, of course, does not mean the minority contended that the field price must necessarily be substi-

tuted for the cost of natural gas as determined by the cost method, (as the majority would assume) but rather that it is a subject which should be considered by the Commission and, therefore, evidence should be permitted as to the fair field price in order that the Commission may consider this element in arriving at "a reasonable and just end result", and that, furthermore, no "just and reasonable end result" could be determined until such evidence was received and weighed and properly allowed for if the circumstances so demanded.

The conclusions of the majority as applied to the record and the facts in this case may be summarized as follows:

Under no circumstances, even under the special facts in this case, is it necessary to consider or weigh any fact except original cost. Under no circumstances and no matter how wide the gap between cost and value is present value to be considered by the Federal Power Commission.

This rule prevails even if the early explorers for gas invested \$3,600,000 in freeholds and leases, and took the gamble of whether the field would produce a sufficient amount of gas to justify the investment; also whether new and better methods could be developed to increase the gas obtainable from shale formation. It turned out in this case that the discoveries and developments of the field were better than the early expectations and that the reserves which have been developed are worth over \$17,000,000. (App. 589). However, the Company is denied all and any advantages and results which might flow from such speculative endeavors and is limited to the inadequate return of 6% on its invested dollars, without any consideration being given to the fact

that the dollar of today is not worth the invested dollar. If the venture had gone the other way and the Company had paid too much for its lands in fee it would never be able to get back a satisfactory return, and perhaps not even its original investment since it would not have the gas which would economically support the investment. The situation clearly raises the question—does the original cost theory inevitably produce “a just and reasonable end result” as the Commission assumes in this case and without investigation of value, or the changed buying power of money?

Justice Jackson, in *Federal Power Commission v. Hope Natural Gas Company*, 64 S. Ct. 281, 51 P.U.R. (N.S.), 193, at 224, makes many pointed criticisms of such treatment of the underlying problems and of the significance attached to mere accounting, and attaches the following note:

“To make a fetish of mere accounting is to shield from examination the deeper causes, forces, movements, and conditions which should govern rates. Even as a recording of current transactions, book-keeping is hardly an exact science. * * * If one cannot rely on accountancy accurately to disclose past or current conditions of a business, the fallacy of using it as a sole guide to future price policy ought to be apparent. However, our quest for certitude is so ardent that we pay an irrational reverence to a technique which uses symbols of certainty, even though experience again and again warns us that they are delusive.”

Justice Clark, of the United States Supreme Court, in the recent case of *United States v. Toronto, Hamilton and Buffalo Navigation Company*, 70 S. Ct. 217, decided December 12, 1949, 70 S. Ct. 217, (a condemnation case) refers to original cost as that “false standard of the past”.

It is generally recognized that the risk of drilling a single well is so great that independent contractors should not be subjected to regulation and should suffer their losses when they find dry holes and receive their gains when they find good wells. It is, however, assumed by the Commission that this situation is entirely and one hundred percent eliminated when there is a substantial number of wells drilled and when the operating costs are allowed in the usual situation of companies holding natural gas rights only by leaseholds. Such consideration, however, fails to recognize that drilling a large number of wells only tends to lessen, not entirely eliminate, the risk, and a number of instances have occurred in natural gas operations in the United States, particularly in the Appalachian field, where whole fields have failed to come up to expectations, and there has been an early and unexpected exhaustion of natural gas. Such a situation developed in the Oriskany sands in West Virginia and in the Potter and Tioga fields in Pennsylvania and can, of course, happen elsewhere and happen here. Such consideration by the Commission also fails to recognize the special advantages which were acquired by Kentucky in purchasing natural gas rights in fee, and when as a result thereof the Company is in a favorable position to produce natural gas below the average cost of gas in the field, and below the average cost of gas where the natural gas rights are held under lease and carry annual rental or royalty payments. We contend that the cases cited by the Commission do not under all circumstances relieve the Commission of the duty of giving consideration to elements of value as well as cost. We think this case requires some consideration of present values. Admitting the vague and uncertain meaning of the so-called "just

and reasonable end result", we nevertheless call the Court's attention to the fact that the cases do hold that some duty and responsibility still rests upon the Commission if their decisions are challenged on the ground that the "just and reasonable end result" is not reached, and if there are reasonable grounds to believe such to be the case. Note the following statement in the majority opinion in the case of *Colorado Interstate Gas Co. v. Federal Power Commission*, 58 PUR (NS), 65, at page 81, which reads as follows:

"We cannot say that the Commission was under a duty to put the leaseholds into the rate base at the valuation urged by Canadian unless we revise what we said in *Federal Power Commission v. Natural Gas Pipeline Co.* (1942) 315 US 575, 586, 86 L ed 1037, 1049, 42 PUR (NS) 129, 62 S Ct 736, and overrule *Federal Power Commission v. Hope Nat. Gas Co.* (1944) 320 US 591, 88 L ed 333, 51 PUR (NS) 193, 64 S Ct 281. We held in those cases that the Commission was not bound to the use of any single formula in determining rates. And in the *Hope Natural Gas Company Case* we sustained a rate order based on actual legitimate cost against an insistent claim that the producing properties should be given a valuation which reflected the market price of the gas. In those cases we held that the question for the courts when a rate order is challenged is whether the order viewed in its entirety and measured by its end result meets the requirements of the act. That is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process.

* * * * *

"Hence, we cannot say as a matter of law that the Commission erred in including the production properties in the rate base at actual legitimate cost. That could be determined only on consideration of the end result of the rate order, a question not here under the limited review granted the case."

Also note the following in the concurring opinion of Justice Jackson on the same point:

(p. 83)

"The opinion in the Hope Natural Gas Company Case laid down fundamental principles of decision in this language: 'Under the statutory standard of "just and reasonable" it is the result reached, not the method employed, which is controlling * * *. It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.' Federal Power Commission v. Hope Nat. Gas Co. *supra* (320 US at p. 602, 51 PUR (NS) at p. 200). This case introduced into judicial review of administrative action the philosophy that the end justifies the means. I had been taught to regard that as a questionable philosophy, so I dissented and still adhere to the dissent. But it is the law of this court, and I do not understand that any majority is ready to reconsider it."

To the same effect note the following statement of the majority opinion in *Panhandle Eastern Pipe Line Company v. Federal Power Commission*, 65 S. Ct. 821, 58 PUR (NS) 100, at page 110:

"The question on review is not the method of valuation which was used but the end result obtained since the issue is whether the rate fixed is 'just and reasonable.'"

Conclusion.

Petitioner submits that your Honorable Court should set aside the Orders here under review and should remand the case to the Commission for further proceedings in accordance with the positions herein taken.

Respectfully submitted,

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April 1, 1950

No. 10401

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

KENTUCKY WEST VIRGINIA GAS COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, RESPONDENT

ON PETITION FOR REVIEW OF ORDERS OF THE FEDERAL
POWER COMMISSION

BRIEF FOR RESPONDENT, FEDERAL POWER COMMISSION

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*United States Court of Appeals
For the
District of Columbia Circuit*

FILED APR 28 1950

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CLERK

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No. 10401

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v.

FEDERAL POWER COMMISSION, RESPONDENT

*ON PETITION FOR REVIEW OF ORDERS OF THE FEDERAL
POWER COMMISSION*

COUNTERSTATEMENT OF THE CASE

Petitioner, Kentucky West Virginia Gas Company, seeks review under Section 19 (b) of the Natural Gas Act (52 Stat. 821, et seq., 15 U. S. C. 717, et seq.), of the Federal Power Commission's orders issued October 8, 1948, November 26, 1948, and June 20, 1949, finding Petitioner's interstate wholesale rates for natural gas sold for resale to Louisville Gas & Electric Company and Pittsburgh and West Virginia Gas Company to be excessive, based on 1948 operations employed as the test period, and requiring an annual reduction in such rates of not less than \$105,601 and \$316,805, respectively, or a total of \$422,406 (I App. 56-58, 77-81, 105-107).

Proceedings before the Commission

This case arose out of a complaint, filed March 17, 1945, by the City of Pittsburgh, Pennsylvania, alleging that Petitioner's rates for natural gas sold for resale to Pittsburgh and West Virginia Gas Company (Pittsburgh Company) and Pittsburgh Company's rates to Equitable Gas Company (Equitable Company) were unjust and unreasonable and in contravention of

the provisions of the Natural Gas Act (Tr. 7791).¹ On April 16, 1945, Petitioner and Pittsburgh Company filed separate similar answers denying the allegations of the complaint (Tr. 7823, 7833).

Upon consideration of the responses, the Commission, on its own motion, by order of April 18, 1945, initiated an investigation of all interstate wholesale rates of Petitioner and Pittsburgh Company, including the rates referred to in the complaint as well as Petitioner's rates to Louisville Gas & Electric Company (Louisville Company). At the same time, the Commission consolidated its investigation and the complaint proceedings for purposes of hearing (Tr. 7844).

Hearings commenced June 11, 1945, and continued thereafter from time to time for 37 days, ending January 8, 1947. The Administrator of the Office of Price Administration, the County of Allegheny, Pennsylvania, and the Public Service Commission of West Virginia participated as intervenors (Tr. 7822, 7850, 7884). The Board of Public Works of West Virginia and the State of West Virginia also intervened but did not participate (Tr. 7885, 7886).

Following submission of briefs and oral argument (Tr. 4321), the Commission, on October 8, 1948, issued its Opinion No. 168 and order (I App. 18-58). The Commission found that Petitioner's interstate rates for the sale of natural gas to Louisville Company and Pittsburgh Company for resale were excessive by not less than \$142,821 and \$428,463, respectively, or a total of \$571,284, based on Petitioner's operations during the test year 1945, and ordered Petitioner to reduce its rates accordingly, effective November 1, 1948 (I App. 56-58). No reduction, however, was ordered in Pittsburgh Company's rates to Equitable Gas Company (I App. 45-46).

On October 29, 1948, Petitioner filed an application for rehearing (I App. 59) and, in connection therewith, certain data respecting the results of Petitioner's operations since the close of the hearings (II App. 763; III App. 1372-1399). By

¹ "Tr. —" references are to the portions of the record as certified by the Commission, but which have not been printed in the Joint Appendix. In citing to the Joint Appendix the reference "App." is used, accompanied by volume and page number.

Opinion No. 168-A and order, concurrently issued on November 26, 1948, the Commission granted rehearing limited to Petitioner's allegations that in certain respects the Petitioner's 1948 operations were more appropriate for test-year purposes than the year 1945 (I App. 78, 80). The Commission, however, denied the application for rehearing on Petitioner's specifications of error with respect to the Commission's rejection of evidence of fair field price of gas, of the reproduction cost of physical properties, of "fair value," and of the purchasing power of the dollar, the 6% rate of return allowed, the annual depletion rate fixed by the Commission, and the Commission's inclusion in available gas reserves of gas to be recovered from the deepening of presently existing shallow wells (I App. 73-74).

In addition, since the data submitted by Petitioner showed that a total minimum rate reduction of \$376,515 was available, even if the allegations as to which rehearing had been granted were properly supported on rehearing, the Commission ordered the rate reduction to that extent made finally effective (I App. 79-81).²

Pursuant to the order granting partial rehearing, further hearings were commenced on February 14, 1949, and concluded on February 18, 1949 (I App. 86). Following submission of briefs, the Commission, on June 20, 1949, issued Opinion No. 168-B and order finding that on the basis of 1948 operations for test-year purposes, the rates to Louisville Company were excessive by \$105,601, and to Pittsburgh Company by \$316,805, or a total of \$422,406 (I App. 102, 106). Accordingly, Petitioner was required to reduce its rates an ad-

² Petitioner filed no petition for review within 60 days from November 26, 1948, as required by Section 19 (b) of the Natural Gas Act with respect to the aspects of the Commission's order issued October 8, 1948, made final by the order issued November 26, 1948, or with respect to the minimum rate reduction of \$376,515 made finally effective by that order. Although the Commission is of the view that such petition for review was required, on the authority of *F. P. C. v. Natural Gas Pipeline Co.*, 315 U. S. 575, and *Panhandle Eastern Pipe Line Co. v. F. P. C.*, 143 F. 2d 488 (C. A. 8), affirmed, 324 U. S. 635, the Commission has not moved to dismiss that part of the petition for review addressed to these determinations. The Court, however, has the right, *sua sponte*, to decline to proceed where jurisdiction does not exist. *Morris v. Gilmer*, 129 U. S. 315, 325; *Mitchell v. Maurer*, 293 U. S. 237, 244.

ditional amount of \$45,891 over and above the \$376,515 made finally effective by the order issued November 26, 1948 (I App. 102, 107).

On July 15, 1949, Petitioner filed a second application for rehearing (I App. 112-119), which, by reason of the Commission's non-action thereon is deemed denied, pursuant to the provisions of Section 19 (a) of the Natural Gas Act. Thereafter, on August 18, 1949, Petitioner filed the instant petition for review in this Court (I App. 1-14).

Petitioner's operations and properties

Petitioner owns and operates large natural gas production, transmission and distribution properties in Kentucky, including extensive gas rights owned in fee and under lease in eastern and central Kentucky. Petitioner also purchases gas from numerous other producers in the area and is engaged in minor oil operations (II App. 189-190, 199-200, 214; III App. 901; Tr. 4921; Ex. 176, Tr. 5524, 5527-5529).

Petitioner sells natural gas for resale to Louisville and Pittsburgh Companies and six other gas utilities, and directly to a number of domestic and industrial users located on its pipeline system. Petitioner, however, is primarily engaged in the production and transmission of natural gas for sale in wholesale quantities to Louisville and Pittsburgh Companies (II App. 189; Ex. 176, Tr. 5534, 5535, 5576). In 1948, for example, of Petitioner's total sales of natural gas, 17% represented sales to Louisville Company and 77% to Pittsburgh Company (Tr. 7752).

Determination of the rate reduction

The Commission, in determining the reasonableness of Petitioner's interstate wholesale rates, found the actual legitimate investment of Petitioner's property in service at December 31, 1948, to be \$27,136,617 (I App. 94). From that amount the Commission deducted only \$12,468,243 as accrued depreciation and depletion (I App. 94), although Petitioner had accrued on its books \$16,963,061,³ all of which had been recouped from

³ \$13,025,639 plus \$4,008,906 (III App. 872) minus \$71,484 (Tr. 4757), representing depreciation and depletion accruals applicable to oil properties.

consumers in rates (I App. 74; II App. 664).⁴ To the resulting amount of \$14,668,374, the Commission added \$680,000 as the working capital allowance (I App. 94). On the basis of the foregoing, the Commission found the appropriate rate base for test-period purposes to be \$15,348,374 (I App. 94).

On the rate base of \$15,348,374, the Commission allowed an annual rate of return of 6% (or a return of \$920,902), which it found was "the maximum reasonable rate which could be allowed" (I App. 40).

In determining the amount of Petitioner's income available for return, the Commission used Petitioner's experience for the year 1948 as the test year, after adjusting annual depletion expense, regulatory commission expenses and special services expenses (I App. 96-99). On this basis, it found Petitioner's rates to be excessive by an amount of \$422,406 annually (I App. 102). In accordance with a stipulation of counsel, it found that \$105,601 of the reduction was applicable to revenues received from Louisville Company and \$316,805 was applicable to revenues received from Pittsburgh Company (I App. 106).

STATUTE INVOLVED

We are lodging with the Clerk a number of pamphlet copies of the Natural Gas Act (52 Stat. 821, et seq., 15 U. S. C. 717, et seq.) for the convenience of the Court in lieu of printing the pertinent sections of the Act as an Appendix to this brief.

SUMMARY OF ARGUMENT

I

A. Under the decisions of the Supreme Court (*F. P. C. v. Hope Natural Gas Co.*, 320 U. S. 591; *Colorado Interstate Gas Co. v. F. P. C.*, 324 U. S. 581; *Panhandle Eastern Pipe Line Co. v. F. P. C.*, 324 U. S. 635), Petitioner concedes that the Commission is not required to adhere to any particular formula for the determination of rates so long as the "end result" of the rate order does not violate constitutional limitations. The depreciated investment rate base method employed in this

⁴The Commission has thus allowed Petitioner to earn 6% on the amount of \$4,494,818, or \$269,689. It would have been fully justified in deducting \$4,494,818 from the rate base (I App. 74).

case is the same one sustained in the cited cases as just and reasonable under statutory and constitutional provisions.

Without any showing that the "end result" of the rate order in this case is confiscatory, Petitioner nevertheless asserts the Commission erred in rejecting evidence of "fair value" because of "special" facts of this case. However, the "special" facts (ownership of an allegedly large amount of gas acreage in fee), concededly give Petitioner "advantages" over other companies. And as for the risks of the business referred to by Petitioner, they are not peculiar to Petitioner, which, in regard thereto, is in a more favorable position than the usual gas company.

B. The Commission's allowance for materials and supplies of \$465,711, determined by applying 1948 price levels to 1945 quantities, is fully supported by the record as correct. Petitioner's operations and construction program admittedly will be substantially the same as in 1945. Since, therefore, the 1945 quantities were considered adequate by Petitioner, the application of the 1948 price levels to the 1945 quantities provides an adequate materials and supplies allowance. Exhibit No. 152-A relied on by Petitioner reflects merely the monthly average balances of materials and supplies per books. It is not indicative of, and was not offered to show, the quantities required for efficient operations.

II

A. The Commission's allowance of \$5,500 annually for regulatory expenses is supported by substantial evidence. The amount allowed is the amount claimed by Petitioner, with the exception of a total sum of \$20,000 representing estimated future payments to Philadelphia Company, Petitioner's parent, expected to be incurred in connection with proceedings before the S. E. C. to determine whether Petitioner's properties should be permitted to remain in Philadelphia Company's control. Such expenditures, the Commission rightly held, are not costs related to rendering service to consumers and should not be borne by gas consumers.

B. The allowance of \$12,502 per year for special services expenses is also adequate. It exceeds the actual expenditures for special services between 1942 and 1947 except for one year,

when the expenditures exceeded the Commission's allowance by \$785. The \$12,502 exceeds the average for the period 1942 through 1947 by approximately \$4,000. It exceeds the normal special services expenses for the future as estimated by Petitioner.

C. In prescribing 3.16 cents per Mcf as the appropriate depletion rate to be used by Petitioner in determining its annual depletion expense for the immediate future, the Commission did not disapprove the staff's method of determining the depletion rate. Contrary to Petitioner's assertion, the staff's method does not mean, and the staff did not agree, that its method means a constantly increasing rate of depletion which would be in excess of 3.16 cents per Mcf.

Under the staff's depletion method, the undepreciated investment is divided by the estimated available gas to be recovered, thus arriving at a unit cost in cents per Mcf. This unit cost is then multiplied by the gas produced to arrive at the annual depletion expense.

Petitioner's claims regarding the inadequacy of the 3.16 cents per Mcf are based upon Petitioner's projections of depletion rates for the years 1946 to 1950, calculated according to the staff's method, but on the assumption that during the period involved there would be no revisions upward of Petitioner's estimates of ultimate recoverable gas reserves.

The Commission properly rejected the depletion rates as based upon an invalid assumption since, the record showed Petitioner has found it necessary each year to revise its estimates of gas reserves upward due to the lack of adequate information upon which to make reasonably reliable estimates, which lack of adequate data continues. On the basis of the Petitioner's experience with revisions, the Commission properly found that the annual rate of 3.16 cents per Mcf would be adequate for the immediate future.

Data subsequently submitted by Petitioner in connection with its application for rehearing confirmed the Commission's findings. Such data showed that net upward revisions had been made in 1945, 1946, and 1947 totalling 21,000,000,000 cubic feet and that consideration of these revisions proved the

3.16 cents per Mcf rate to be adequate. For example the 1945 and 1946 rates are actually 3.017 and 3.092 cents per Mcf, respectively. The depletion rate prescribed has thus met the test of experience.

The Commission properly included reserves to be recovered from the deepening of shallow wells in determining the depletion rate of 3.16 cents per Mcf. It is conceded that part of the cost of the original drilling of the shallow well should be prorated to the gas to be recovered from the deepened well and that unless such reserves are included at this time, the costs associated with the shallow well may have all been amortized by the time the deeper drilling takes place. It is not contended that the Commission's treatment of such reserves will deprive Petitioner of the costs to be incurred when the wells are deepened, for such costs will then be included in the depletable investment base.

III

The 6% rate of return allowed by the Commission is fair and reasonable. The evidence upon which it is based is substantially the same kind of evidence which this and other courts have uniformly held sufficient to support the Commission's findings on rate of return.

Petitioner is better situated than the usual gas company. It serves a stable and well-established market, consisting virtually of only two customers, to whom in 1948 it sold 94% of its gas for resale and from whom it received 96% of its revenues. Petitioner's own witnesses have described its position as "unique" and "enviable" from the standpoint of available gas reserves and proximity of reserves to market. Its president has testified that if Petitioner lost its present customers it would have no difficulty marketing gas in a competitive market.

From the "end result" view of the rate order, the return on the equity is at least 8.03%; more than adequate—as shown by the evidence submitted by Petitioner's own rate of return witness and by the staff's rate of return witness.

ARGUMENT

On this review, Petitioner seeks to re-open various phases of rate-regulation questions which the Supreme Court has resolved adversely to the very contentions now advanced by Petitioner, and, on a number of the questions presented, to have this Court reweigh the evidence considered by the Commission.

The questions presented on this review are:

(A) As to rate base—

(1) Whether, as a matter of law, the Commission erred in establishing an investment rate base as the base upon which Petitioner is entitled to earn a fair return.

(2) Whether the Commission correctly found from the evidence that a working capital allowance for materials and supplies of \$465,711 is adequate to enable Petitioner to operate efficiently.

(B) As to operating expenses for the test year 1948—

(1) Whether the Commission correctly found from the evidence that an allowance of but \$5,500 annually for regulatory commission expenses is adequate for Petitioner.

(2) Whether the Commission correctly found from the evidence that an allowance of but \$12,502 annually for special services fees is adequate for Petitioner.

(3) Whether the Commission's allowance of 3.16 cents per Mcf as the annual depletion rate to be applied in determining the annual depletion expense charge represents a proper analysis of the evidence.

(C) As to rate of return—

Whether the Commission properly found from the evidence that 6% is a fair rate of return for Petitioner.

I

**The Commission properly employed an investment rate base
of \$15,348,374**

The Commission employed an investment rate base in fixing Petitioner's rates, consisting of actual legitimate investment in

gas plant in service of \$27,136,617, less accrued depletion and depreciation of \$12,468,243, plus working capital of \$680,000, or a rate base of \$15,348,374 (I App. 94).

Petitioner contends that the Commission erred in utilizing this rate base for two reasons. First, because the Commission refused to receive and consider proffered evidence of the reproduction cost of its physical properties, the purchasing power of the dollar, the fair field price of its gas and the fair market value of its leaseholds (Pet. Br. 48), all of which proffered evidence Petitioner conceded at the hearings (II App. 591) and concedes in its brief (Pet. Br. 48) purports to show the "fair value" or "present value" of Petitioner's property and gas reserves. Second, because the Commission allowed \$465,711⁵ as the materials and supplies component of working capital instead of \$726,901 claimed by Petitioner (Pet. Br. 38-40).

A. Rejection of "fair value" evidence was proper

The propriety of the investment rate base and rejection of evidence purporting to show the "fair value" of Petitioner's property and gas reserves is too well established to require argument. In all the cited cases, the courts sustained as just and reasonable, under statutory and constitutional provisions, gas rates prescribed by the Commission using the same depreciated investment rate base method it employed here. *F. P. C. v. Hope Natural Gas Co.*, 320 U. S. 591; *Colorado Interstate Gas Co. v. F. P. C.*, 324 U. S. 581; *Panhandle Eastern Pipe Line Co. v. F. P. C.*, 324 U. S. 635, 649; *Cities Service Gas Co. v. F. P. C.*, 155 F. 2d 694, 699 (C. A. 10), cert. denied, 329 U. S. 773; *Interstate Natural Gas Co. v. F. P. C.*, 156 F. 2d 949, 951 (C. A. 5), affirmed, 331 U. S. 682.

Petitioner argues for consideration of "fair value" although it admits (Pet. Br. 49) that the Supreme Court has held that the Natural Gas Act does not require the Commission to adhere to any particular formula for the determination of rates so long as the "end result" of the rate order does not produce

⁵ Petitioner in its brief refers to the materials and supplies allowance as \$463,022. The allowance is actually \$465,711, as follows: Total allowance of \$680,000 less cash allowance of \$214,289 equals \$465,711 as the materials and supplies allowance.

rates which violate constitutional limitations. While arguing for a "fair value" rate base, Petitioner wholly fails to show that the "end result" in this case is confiscatory,⁶ or to meet the basic objection to such a base stated by Mr. Justice Douglas in the *Hope* case, *supra* (320 U. S. 601):

The heart of the matter is that rates cannot be made to depend upon "fair value" when the value of the going enterprise depends on earnings under whatever rates may be anticipated.⁷

In asking this Court to re-examine the settled law and hold contrary thereto, Petitioner alleges that the facts of this case are "special" (Pet. Br. 51), referring in that connection to Petitioner's ownership of a substantial portion of its gas reserves in fee whereas other natural gas companies hold most of their reserves under leases calling for annual rentals and royalties, and to the risks inherent in the natural gas business (Pet. Br. 50, 51-52, 53). But Petitioner concedes that ownership of gas reserves in fee gives it "advantages not possessed" by other natural gas companies (Pet. Br. 50). And as to the risks of the business, they are not peculiar to Petitioner. They are common to all natural gas companies, including those involved in the cited cases. True, the degree of risk inherent in the business may vary from one natural gas company to another, but that is a factor bearing on the rate of return to be allowed and one which the Commission considered in that connection. Moreover, Petitioner's own witnesses concede that as to reserves and markets (present and future) Petitioner is in a more favorable position than other natural gas companies (II App. 127, 128, 198, 682, 683).

B. Commission's working capital allowance for materials and supplies was proper

Using 1948 as the test year, the Commission allowed \$680,000 for working capital, of which \$214,289 represents cash working capital to meet operating expenses requiring cash before customers' payments are received, and \$465,711 represents ma-

⁶ We show at pages 29 to 30, *infra*, it cannot make such a showing.

⁷ Petitioner's counsel agreed (II App. 597) that the proffered evidence of "value" depends upon earnings.

terials and supplies reasonably necessary for the efficient operation of the utility property (I App. 92-94).

Petitioner contends that the proper allowance for materials and supplies is \$726,901 and that in allowing only \$465,711 the Commission did so without any basis in the record, and departed from the formula employed in fixing the allowance for materials and supplies when it had used 1945 as the test year in Opinion No. 168 (Pet. Br. 38-39).

No question of formula or departure from formula is involved in the allowance of \$465,711 for materials and supplies or in the earlier allowance of \$364,972. Whereas the average of Petitioner's monthly balances of materials and supplies in 1945 of \$364,972 was considered reasonably necessary for maintenance of efficient operations and therefore allowed, the evidence on rehearing did not support any such conclusion as to 1948 averages (I App. 92). Thus, the difference is one of evidence rather than of formulae.

The evidence showed that the 1945 quantities of materials and supplies had been considered adequate by Petitioner to carry on its operations and construction program and that Petitioner's construction program thereafter had been, and would continue to be in the future, substantially the same as the program carried on in 1945 (II App. 784, 785, 787). The evidence showed, however, that prices of materials had increased 26.86% since 1945 (II App. 790). The Commission accordingly found properly that the application of the increased prices to the 1945 quantities of materials and supplies would provide a proper materials and supplies allowance (I App. 94) and accordingly, by this method, increased its earlier allowance of \$364,972, using 1945 as the test year, to \$465,711.

In an effort to secure a reweighing of the evidence by this Court, Petitioner refers (Pet. Br. 38, 39-40) to Exhibit No. 152-A (III App. 963), introduced through Petitioner's witness Ruemmele, showing materials and supplies of \$726,901, and to witness Ruemmele's testimony that the 1945 quantities of materials and supplies could not be relied on in determining adequate quantities because the 1945 balances represented operations on "a hand-to-mouth basis" (II App. 783), as showing the inadequacy of the Commission's allowance. But

neither Exhibit No. 152-A nor Ruemmele's "hand-to-mouth" description of the 1945 quantities provides any support for Petitioner's contention.

As to Exhibit No. 152-A, it merely reflects the average monthly balances per books (III App. 963) but does not establish that such quantities are either reasonable or necessary for maintenance of efficient operations. Indeed, when witness Ruemmele was pressed on cross-examination for an opinion regarding the reasonableness or propriety of the quantities shown in Exhibit No. 152-A, counsel for Petitioner objected, saying (II App. 783):

* * * I am not presenting him as an independent expert to express an opinion as to whether that comes out with a right answer or a wrong answer.

Ruemmele, it developed, was simply presenting a mathematical result (II App. 782). Further, although Petitioner's operating official, who determines Petitioner's need for materials and supplies (II App. 786), testified on Petitioner's behalf, Petitioner offered no testimony on required quantities of materials and supplies through him. Finally, that the quantities shown in Exhibit No. 152-A are excessive appears from the testimony of Petitioner's operating official Beecher who, when asked on cross-examination as to the source of cash available for Petitioner's proposed construction program, testified that at least \$90,000 would come from a reduction in the materials and supplies balances (II App. 831). In other words, he was of the opinion that the average monthly balances in an amount of at least \$90,000 are not necessary to carry on efficient operations and maintenance.

That Ruemmele's "hand-to-mouth" characterization of the materials and supplies allowance of \$364,972, based on 1945 operations, was misleading was proved out of the same witness' mouth when he admitted that Petitioner's own materials and supplies claim had been about the same as the amount allowed—"close enough to ignore any variations," he agreed (II App. 787); that Petitioner had considered \$364,972 sufficient to efficiently carry on its operations and construction program (II App. 787); and that the "hand-to-mouth" state-

ment was hearsay picked up just prior to the hearing (II App. 787).

Further demonstration of the adequacy of the Commission's working capital allowance is found in the fact that tax accruals are available as a source of working capital and that such accruals in 1948 amounted to \$475,905 (II App. 780-781). And also in the fact that the cash working capital allowance of \$214,289 is based on a 45-day lag, whereas the actual lag between payment of bills by Petitioner and receipt of revenues from its customers is 35 days (Ex. 193, Tr. 5994). While the Commission did not reduce the allowance by reason of these factors, they cannot be ignored in appraising the fairness of the allowance for working capital (I App. 93).

It plainly appears, therefore, that the Commission's allowance for materials and supplies is fully supported by substantial evidence.

II

The operating expense adjustments were proper

In determining the extent to which the rates under scrutiny are excessive it is necessary to use figures which could reasonably be expected to be typical or characteristic of the period for which the rates fixed will be in effect. The Commission made several adjustments to the 1948 regulatory expenses, special services expenses, and annual depletion expense for that reason (I App. 96-99). Petitioner takes exception to the adjustments.

A. Regulatory expense adjustments were proper

The regulatory expense adjustments, to which Petitioner appears to take exception,⁸ involved the exclusion from the test year 1948 of \$5,191.81 of rate case expenses incurred in connection with this case, and of \$20,000 expected to be paid by Petitioner to its then parent, Philadelphia Company in 1949

⁸ We say "appears" because it is not clear whether Petitioner is still pressing its objection to the rate case expense adjustment. In its brief it lists the rate case expense adjustment as one of the adjustments complained of, but expressly states it will not discuss the adjustment (Pet. Br. 36).

and 1950, in connection with a proceeding before the Securities and Exchange Commission.⁹

1. *Rate case expenses.*—The \$5,191.81 was excluded because it had been fully recovered (I App. 96-97; II App. 800, 805). Citation of authorities is hardly required to support the proposition that fully recouped, nonrecurring expenses are properly excluded for test-year purposes.

The nonrecurring nature of the \$5,191.81 and the propriety of the exclusion of that particular amount is not denied by Petitioner (Pet. Br. 36). But Petitioner argues (Pet. Br. 36), the fact that the particular \$5,191.81 may have been recovered or is of a nonrecurring nature is beside the point, because Petitioner is still incurring rate case expenses for which allowance must be made.

Petitioner thus implies that, in adjusting regulatory expenses for test-year purposes, the Commission made no allowance for rate case and other regulatory expenses during the period when its rate order would be effective. The implication is at odds with the facts.

Petitioner estimated regulatory expenses for 1949 to 1952 as follows:

	1949	1950	1951	1952	Grand total
Federal Power Commission.....	\$10,000				\$10,000
Kentucky Public Service Commission.....	1,000	\$1,000			2,000
Securities and Exchange Commission.....	10,000	10,000			20,000
Unassigned.....			\$5,000	\$5,000	10,000
Total.....	\$21,000	\$11,000	\$5,000	\$5,000	\$42,000

Of this four-year aggregate amount of \$42,000, the Commission allowed all but the \$20,000 associated with the Securities and Exchange Commission, the propriety of which exclusion we discuss immediately below. The allowance of the \$22,000 was

⁹ Since the close of the hearings, as a result of the S. E. C. proceedings, Philadelphia Company disposed of its holdings of Petitioner's stock to Equitable Gas Company and disposed of all of Equitable's stock to an underwriting syndicate. As a result, Petitioner is no longer in the Philadelphia Company System.

on the basis of amortization over the estimated period of four years (I App. 98), or \$5,500 annually (I App. 98). The propriety of amortizing expenses of this type is conceded by Petitioner (Pet. Br. 36, 38).

2. *Expenses related to Securities and Exchange Commission proceedings.*—Petitioner estimated payments to Philadelphia Company aggregating \$20,000 "in connection with the proceedings before the Securities and Exchange Commission involving the Philadelphia Company" (II App. 805). The purpose of the S. E. C. proceeding was to determine whether Petitioner's properties, together with other gas properties owned by Philadelphia Company, constituted a single integrated gas utility system, and whether control of Petitioner's properties should be retained in Philadelphia Company (Pet. Br. 37).

The Commission refused to include in the test year provision for the estimated expenditures (I App. 98).

Petitioner complains of this exclusion, erroneously asserting that the Commission refused to make such provision on the ground that "the only company involved" in the proceedings before the Securities and Exchange Commission "was the holding company" (Pet. Br. 38).

The basis for the disallowance was, however, the fact that Petitioner had not established that this type of expenditure "rightfully" belongs "among costs of service to Kentucky's utility customers," but that "on the contrary, it is believed that the correct inference to be drawn from the evidence of record is that it is not that type of cost but is an expenditure which benefits the stockholders alone, in this instance the affiliated companies" (I App. 97).

The Commission was plainly right for expenditures incurred in trying the issues referred to are not costs related to rendering service to consumers. In fact, nowhere does Petitioner suggest that the "vital interest" of Petitioner, to which it refers (Pet. Br. 38), or Petitioner's "own interests" (Pet. Br. 38), are synonymous with consumer interests or affect them in such manner as would justify saddling them with the costs of defending the holding company structure.

B. Special services expenses adjustment was proper

Petitioner's operating expenses for 1948 showed that Petitioner had incurred and recouped from consumers "Special Services" expenses of \$37,823.34 (II App. 790; III App. 861). Included in this amount was \$25,321.24 paid to tax counsel for services rendered between 1945 and 1948 on federal income tax matters covering tax years 1939 to 1943 (II App. 790-791). For test-year purposes, the Commission excluded the \$25,321.24, leaving provision for special services expenses of \$12,502 per year, on the ground that the expenses of \$25,321.24 "are quite clearly non-recurring expenses, which, if permitted to remain in the accounts, would distort 1948 expenses for test purposes" (I App. 99).

Petitioner concedes that the \$25,321 is "undoubtedly substantial and non-recurring" in that amount, but asserts that the kind of service involved is recurring and that the allowance of \$12,502 is, therefore, inadequate (Pet. Br. 37). The evidence, however, supports the Commission's finding that the \$12,502 is adequate.

The \$12,502 is greater than actual expenditures for special services for any preceding year between 1942 and 1947, except 1946, which exceeded the allowance by \$785 (I App. 98; III App. 840, 846, 855). It is greater than the average of \$8,158 for this period (*ibid.*). The \$12,502 also exceeds the estimated special services expenses for each of the years 1950, 1951, and 1952 by \$502 each year (II App. 818). The \$12,502 is less than the estimate only in 1949, when the estimate was \$22,000 (II App. 818), but this amount is clearly attributable to abnormal and non-recurring expenses which should be omitted for test-year purposes (*ibid.*).¹⁰

C. The annual depletion rate prescribed by the Commission is adequate

The Commission in Opinion No. 168 prescribed 3.16 cents per Mcf as the proper rate of depletion to be applied to Peti-

¹⁰ It should be noted that, even if the \$9,500, by which the 1949 estimate exceeded the Commission's allowance, were considered appropriate for test-year purposes, amortization over a period of three to five years would have been proper (Pet. Br. 38), which means that, on a three-year amortization basis, only \$3,167 would be added to the \$12,502, and on a five-year basis, only \$1,900.

tioner's depletable investment for the purpose of determining annual depletion expense for the immediate future (I App. 37; III App. 1375). In an application for rehearing, filed October 29, 1948, Petitioner asserted the prescribed rate was inadequate, and on November 1, 1948, submitted data for Commission consideration to support the claim (I App. 62-63; III App. 1372).

Upon consideration of the data submitted, the Commission in Opinion No. 168-A denied rehearing on the question of the adequacy of the depletion rate (I App. 73-74, 77, 78). At the same time, however, it granted rehearing on other aspects of its rate order issued October 8, 1948 (I App. 78, 80).

At the rehearing, Petitioner nevertheless sought to introduce documentary evidence respecting the adequacy of the 3.16 cents per Mcf (Exs. 236-245, II App. 771-779). Such evidence was substantially identical with the data submitted in connection with the application for rehearing (Cf. *e. g.*, III App. 1351 and 1399). On staff counsel's objection, the Trial Examiner excluded the evidence as not relevant to the issues included in the Commission's order issued November 26, 1948, granting limited rehearing (II App. 771-779). In Opinion No. 168-B and order issued June 20, 1949, this ruling was sustained by the Commission (I App. 87-88).

Petitioner attacks the 3.16 cents per Mcf depletion rate, contending:

(1) The Commission's use of that rate, in Opinion No. 168-A, to determine the 1948 depletion allowance constituted a reversal of its earlier approval, in Opinion No. 168, of the staff's method of determining the depletion rate (Pet. Br. 10).

(2) The rate is insufficient and inadequate¹¹ (Pet. Br. 27, 28); and

¹¹ At page 28 of its brief, Petitioner asserts that the Commission's findings on the subject of the depletion rate are not adequate. Whether or not Petitioner by this objection actually challenges the adequacy of the findings or simply means that the Commission reached an incorrect result on the evidence (as is claimed in the very next sentence (Pet. Br. 28)), is not clear. In any event, having failed to allege on rehearing that the findings are inadequate (I App. 62-63, 116), Petitioner cannot now raise that objection. See cases cited in footnote 2, *supra*, and sections 19 (a) and (b) of the Act.

(3) The Commission determined the rate by improperly including gas reserves available from future deepening of existing shallow wells without including the cost expected to be incurred in deepening such wells (Pet. Br. 33).

We shall discuss these contentions seriatim.

1. *No reversal of Commission position on proper depletion rate involved.*—Even if there were a reversal of position by the Commission the only pertinent inquiry remains simply—is the depletion rate prescribed supported by substantial evidence. *Safe Harbor Water Power Corporation v. F. P. C.*, 179 F. 2d 179, 199 (C. A. 3), application for a writ of certiorari on other grounds filed in the Supreme Court on March 28, 1950 (No. 709, Oct. Term, 1949).

Furthermore, if, as Petitioner contends, the reversal of position were material, Petitioner should have filed a second petition for rehearing within 30 days after the order of November 26, 1948, was issued. Having failed to do so, Petitioner has no standing to object here on this ground to the Commission's findings in Opinion No. 168-A.¹²

But no reversal of position occurred. Petitioner arrives at its conclusion that there was by asserting, without record references, that the staff's method of determining the annual depletion rate, approved by the Commission in Opinion No. 168, results in higher and higher depletion rates for each of the years subsequent to 1945 (Pet. Br. 10, 12); and that this was admitted by the staff (Pet. Br. 12). Consequently, Petitioner concludes, the use of 3.16 cents per Mcf for 1945 and the same rate for 1948 in determining the 1948 depletion allowance in Opinion No. 168-A, constituted abandonment of the Commission's earlier position in Opinion No. 168.

The record shows that at the hearings, preceding the issuance of Opinion No. 168 and order of October 8, 1948, contrary to Petitioner's assertion (Pet. Br. 12), the staff did not agree that its method of determining the appropriate depletion rate would mean constantly increasing rates subsequent to 1945. The staff simply placed in evidence what it believed

¹² See cases cited in footnote 2, *supra*, and sections 19 (a) and (b) of the Act.

was an appropriate rate for 1945. This is made clear by the response of staff witness Walters to a direct question from Petitioner's counsel on that point, as follows (II App. 680):

Q. Have you given any consideration whatever to the depletion rates of the future beyond the year 1945?

A. No, sir; I have not.

Petitioner's counsel then requested the witness to prepare "a determination of what those depletion rates should be for the years 1946 to 1950", asserting (Tr. 3689):

* * * we take the position that the question of what the depletion rates are to be in the future is a far more important question than any rates which have been developed for the past.

Counsel for the staff objected, saying (Tr. 3691):

* * * we are being asked to project it on the basis of the figures put in by the Company with which we do not necessarily agree, * * *.

In the ensuing colloquy, Petitioner's counsel withdrew the request (Tr. 3692) and Petitioner decided, instead, to make its own presentation, requesting only that the staff check such presentation for the purpose of advising Petitioner whether the mechanics of the staff's method of determining the depletion rate had been properly applied (Tr. 3691-3692).

Thereafter, Petitioner introduced in evidence Exhibits 204 and 206 (II App. 713, 714). In Exhibit 204 Petitioner showed depletion rates for 1946 to 1950 applying the staff's methods *but using Petitioner's estimates of future gas reserves, of gas production and gas plant additions and retirements* (II App. 713-714). Exhibit 206 differed from Exhibit 204 only in that the rates of depletion there shown were based on gas reserves which excluded reserves to be secured from deepening shallow wells (II App. 715).

The staff agreed only that the mathematics of its methods had been correctly applied, but did not agree that the figures are the results of its methods (Pet. Br. 18) or approve the results shown (II App. 714).

On the basis of these exhibits, Petitioner proposed "the use of an average of rates which rise year by year (1946 to 1950 inclusive)" and contended that the 1945 staff rate of 3.16 cents per Mcf "will not compensate the company for its increased costs" (I App. 35). The Commission, however, while approving the staff's methods of calculating a depletion rate, rejected the results shown in Exhibits 204 and 206, because a basic component of the calculations, Petitioner's estimates of ultimate recoverable gas reserves in 1946 to 1950 were seriously understated (I App. 34-37). It found upon the basis of proper estimates of gas reserves that the 1945 depletion rate was proper for the immediate future. Thereafter, in Opinion No. 168-A, the Commission consistently used 3.16 cents per Mcf in computing the annual depletion allowance for 1948 (I App. 79).

Thus, the following is clear:

1. The Commission rejected no staff determinations of depletion rates subsequent to 1945—none had been presented by the staff.
2. The staff did not agree with Petitioner that the depletion rate would rise year by year.
3. The staff simply made a mathematical check of Petitioner's Exhibits 204 and 206 but did not approve the results.
4. The Commission approved the staff method of determining the depletion rate, but rejected the results shown by Petitioner because they were based on understated estimates of gas reserves.
5. The Commission found in Opinion No. 168 that the 1945 depletion rate as computed by the staff was appropriate for the immediate future.
6. The Commission consistently applied that rate in Opinion No. 168-A.

We now show that the Commission's prescription of a 3.16 cents per Mcf depletion rate and rejection of the results in Petitioner's Exhibits 204 and 206 are supported by substantial evidence.

2. *The Commission properly prescribed a depletion rate of 3.16 cents per Mcf.*—Under the staff's depletion method, the undepreciated investment is divided by the estimated available gas to be recovered, thus arriving at a unit cost in cents per Mcf. This unit cost is then multiplied by the gas produced to arrive at the annual depletion expense (III App. 1047; Pet. Br. 16).

Thus, contrary to Petitioner's assertion (Pet. Br. 16), the accuracy of the estimate of recoverable gas reserves is a relevant and crucial consideration in determining the propriety of depletion rates. Obviously, if the estimate of recoverable gas reserves is inaccurate, the depletion rate, so computed, is inaccurate. If the gas reserve estimates are understated, the depletion rate is too high, and conversely, if the estimated reserves are too high, the rates are too low. It was on the basis of conclusive evidence showing that Petitioner's depletion rates were computed on unreasonably low estimates of gas reserves that the Commission rejected such rates.

From 1936 through 1944, Petitioner found it necessary each year to revise its estimates of ultimate recoverable gas reserves, resulting in upward revisions on 1,107 wells and downward revisions on only 347 wells (Ex. 56, III App. 899; II App. 244). This resulted in net revisions upward of estimates of ultimate recovery of gas in each of those years, as follows (Ex. 56, III App. 899):

Net increase in cubic feet

1936-----	6, 095, 100, 000	1942-----	1, 985, 000, 000
1937-----	9, 537, 600, 000	1943-----	3, 500, 000, 000
1938-----	13, 612, 300, 000	1944-----	14, 299, 300, 000
1939-----	8, 703, 000, 000		
1940-----	22, 752, 500, 000	Total-----	84, 223, 400, 000
1941-----	3, 738, 200, 000		

The reason for these revisions is clear. It is the fact that Petitioner has a large percentage of wells on which there are insufficient data on production and rock pressures to plot pressure decline curves from which reasonably reliable estimates can be made (II App. 210; III App. 974).¹³ As to new

¹³ Even pressure decline curves are subject to periodic correction since true rock pressures are often difficult to secure (II App. 212).

wells, of course, this is always the case (II App. 210; III App. 1081-1084).

The large lack of adequate information, necessitating constant upward revisions of estimated recoverable gas reserves has, in part, been due to the urgent gas requirements of the war period, when well drilling was accelerated, and when wells, because of the demand for gas, could not be taken out of service to secure the information essential to reliable estimates (I App. 210-212). Exhibit 55 provides a dozen examples of the revisions necessary on individual wells as more data become available for reliable estimating (III App. 875-897). For example, in the case of one well (No. 371), the estimate made in 1934 of 262,000 Mcf was revised in 1942 to 470,000 Mcf (II App. 206; III App. 877). On another well drilled in 1935 (No. 5200), the estimate of 970,000 Mcf in 1936 was in 1944 revised to 2,360,000 Mcf (III App. 879).

To an important extent, Petitioner continued to suffer from a lack of adequate information at the end of 1945. Inadequate information on 499 of 1,047 wells, or 48% of the total number, forced Petitioner to resort solely to judgment estimates on those wells (III App. 974, 983-1037, 1081-1084).

Yet, notwithstanding this history of upward revisions in gas reserves year after year and the continued lack of data, Petitioner, in submitting Exhibits 204 and 206 for the purpose of showing that either under the application of the staff's methods of determining depletion rates, or Petitioner's methods,¹⁴ the estimated depletion rates would exceed 3.16 cents per Mcf and would increase each year, assumed there would be no further continuance of its experience, continued year after year for nine years, of revising its estimates of recoverable gas upward, and hence reducing its depletion rate (II App. 713, 919, 921; III App. 1293, 1319).

¹⁴ Petitioner has abandoned any contentions based on the Commission's rejection of the estimated rates of depletion developed per Company methods (Pet. Br. 11). We, therefore, analyze the evidence in relation to the estimated depletion rates per staff methods only. However, we call the Court's attention to the fact that the Petitioner's estimates per staff and Company methods were rejected for the same reason (I App. 34-37).

It presented such testimony on two bases—including gas reserves from future deepened wells (Ex. 204, III App. 1293) and excluding such reserves (Ex. 206, III App. 1319). In one respect, however, the rates shown in Exhibits 204 and 206 were not in accord with the staff's methods. Whereas the staff *depreciated* well equipment, Petitioner included a *depletion* allowance for well equipment in its calculations with the result that the rates in Exhibits 204 and 206 were slightly higher than they would have been if staff methods had been followed in this respect. In order to present a proper comparison between the 3.16 cents per Mcf prescribed and the rates calculated by Petitioner, from the standpoint of method alone, the rates shown in Exhibits 204 and 206 have been adjusted to eliminate that departure from staff method. So adjusted, Petitioner's estimated depletion rates were as follows: ¹⁵

<i>Including reserves from deepened wells (Ex. 204, III App. 1293)</i>		<i>Excluding reserves from deepened wells (Ex. 206, III App. 1319)</i>	
<i>Per staff method</i>		<i>Per staff method</i>	
1945_____	3. 1577	1945_____	3. 2910
1946_____	3. 4304	1946_____	3. 5655
1947_____	3. 6824	1947_____	3. 8171
1948_____	3. 9175	1948_____	4. 0513
1949_____	4. 1385	1949_____	4. 2702
1950_____	4. 3369	1950_____	4. 4654

The Commission, however, concluded that the evidence demonstrated the past experience would continue and that therefore the assumptions inherent in Petitioner's depletion rates rendered them invalid. The Commission further concluded that on the basis of the Petitioner's experience with revisions, the annual rate of depletion of 3.16 cents per Mcf would be adequate for the immediate future (I App. 37).

¹⁵ The adjustment is merely arithmetic made solely from the data presented by Petitioner at III App. 1293 and 1319. To illustrate: At III App. 1293 Petitioner has calculated a rate of 3.4972 for the year 1945 by dividing \$872,342.25 by the production in that year of 24,943,900 Mcf. The \$872,342.25 includes the allowance for gas well equipment of \$84,688.72. Excluding the \$84,688.72, as it should be to conform to staff methods, the \$872,342.25 is reduced to \$787,653.53. Dividing \$787,653.53 by 24,943,900 Mcf produces the rate of 3.1577 cents per Mcf shown above for the year 1945. The rates shown herein are derived by following the same procedure for each of the years.

These findings were confirmed by data, specifically directed to the adequacy of the prescribed depletion rate, submitted by Petitioner for the Commission's consideration in connection with the application for rehearing. Those data showed that there had been upward revisions in recoverable gas reserves of old wells drilled in prior years of 9,213,000,000 cf in 1945 and in 1946, and 11,250,100,000 cf in 1947 (III App. 1385). Additionally, the data showed that in 1946 Petitioner in determining annual depletion expense had actually used a depletion rate of 3.26 cents per Mcf instead of the 3.43 or 3.57 cents per Mcf predicted, and that in 1947 it had used for the same purpose a rate of 3.34 cents per Mcf instead of the forecasted rates of 3.68 or 3.82 cents per Mcf (*supra*, p. 24).

But even the 3.26 and 3.34 cents per Mcf rates used in 1946 and 1947 by Petitioner were overstated and subject to adjustment. For example, the 1946 rate of 3.26 does not reflect the upward revision referred to above of estimates of gas reserves applicable to old wells drilled prior to 1946 and to new wells drilled in 1946 (III App. 1385). If Petitioner had reflected these revisions, the 1946 rate would be 3.092 cents per Mcf.¹⁶ Thus, the prescribed rate of 3.16 cents per Mcf is actually liberal—by \$17,907.¹⁷ Similarly, reflecting applicable adjustments to 1945 reserves the rate in 1945 is actually 3.017 cents per Mcf rather than 3.16, thus allowing Petitioner \$35,670 more than was required.¹⁸

¹⁶ Depletion base of \$6,677,682.48 divided by Gas Reserve Estimate of 215,943,100 Mcf equals 3.092 cents per Mcf. The depletion base is made up of \$5,414,470.38 (III App. 1377), \$679,148.18 (III App. 1379) and \$584,063.92 (III App. 1381). The gas reserve estimate is made up of 204,693,000 Mcf (III App. 1385) and 11,250,100 Mcf (III App. 1385).

¹⁷ Thus: Production in 1946 of 26,333,900 Mcf (III App. 1385) times 3.092 cents per Mcf equals annual depletion allowance of \$814,244 as compared to the actual allowance of \$832,151, derived by multiplying 1946 production by 3.16 cents per Mcf.

¹⁸ Depletion base of \$6,261,781.91 divided by Gas Reserve Estimate of 207,524,500 Mcf equals 3.017 cents per Mcf. (Depletion base is made up of \$4,996,403.83 (III App. 1241), \$653,338.33 (III App. 1243) and \$612,039.75 (III App. 1245) and the Gas Reserve Estimate is 198,311,500 Mcf (III App. 1241) plus revisions of 9,213,000 Mcf (III App. 1385)). Production in 1945 of 24,943,900 Mcf (III App. 1375) times 3.017 cents per Mcf equals depletion allowance of \$752,557.46 as compared to the \$788,227.24 allowed by prescribing the 3.16 cents per Mcf rate.

We submit, therefore, that the Commission's depletion rate of 3.16 cents per Mcf is fully supported by evidence, has met the test of experience and should be allowed to stand. *Panhandle Eastern Pipe Line Co. v. F. P. C.*, 143 F. 2d 488, 498, affirmed, 324 U. S. 635. Cf. *F. P. C. v. Hope Natural Gas Co.*, 320 U. S. 591, 615.

3. *Inclusion of reserves from deeper drilling proper.*—In determining the depletion rate of 3.16 cents per Mcf, the Commission included in the estimates of ultimate recoverable gas reserves 12,600,000 Mcf representing gas reserves to be recovered through the deepening of shallow wells (I App. 33-34).

There is no dispute that Petitioner recovers gas from several formations, drilling deeper from formation to formation as gas in commercial quantities nears exhaustion in the shallow formation (II App. 193); nor is it disputed that Petitioner has followed the practice of deepening shallow wells and that such deepening has resulted in additional reserves which have been included by Petitioner in its estimates of reserves (II App. 265).

The estimated reserves recoverable through deeper drilling are not disputed, nor is it disputed that when the deepening takes place, and costs are incurred, they will be reflected in depletable investment and will be recovered through the rate of depletion then applicable.

Petitioner's only complaint appears to be that the gas reserves recoverable from deeper drilling of shallow wells should be included only at the time that the deepening takes place, at which time the costs will also be included, because, it may fairly be said, Petitioner prefers a higher depletion allowance now and a lower one later rather than the reverse of that situation (Pet. Br. 34).

Petitioner's witness Ruemmele conceded (II App. 267-268), and as the Commission properly found (I App. 34), that part of the cost of the original drilling of the shallow well should be prorated to the gas recovered as a result of deepening of the well. Unless the reserves are included at this time, Ruemmele conceded (II App. 267-268), by the time the deeper drilling takes place, the cost of drilling the shallow well apportionable

to the deeper portion thereof may have all been amortized. This, of course, applies to the cost of the leasehold when one is involved. That cost is unquestionably allocable to any and all gas to be recovered from drilling on the leasehold.

In short, inclusion of reserves from deeper drilling at this time will assure apportionment of the cost of drilling the shallow well to the gas recoverable from deeper formations, as well as apportionment of the cost of the leasehold without depriving Petitioner of recoupment of all of its investment (II App. 679).

Since it is not denied that the inclusion at this time only of the reserves will not operate to deprive Petitioner of any part of its investment when made, and the evidence indisputably supports the Commission's finding (I App. 34) that inclusion of the reserves from deeper drilling is appropriate to assure apportionment of the cost of drilling the shallow well to production from the lower level, there is no basis for reversal. *Safe Harbor Water Power Corporation v. F. P. C.*, 179 F. 2d 179, is in point. In that case, Safe Harbor contended for the sinking-fund method of depreciation and objected to the straight-line method of depreciation, in part, because the former method would provide a higher rate base over a long period of time (179 F. 2d 199). It was conceded, however, that either method would in the end enable the company to recover its full costs. The United States Court of Appeals for the Third Circuit accordingly rejected this objection to the straight-line method of depreciation.

III

The 6 percent rate of return prescribed was proper

The Commission found a 6% rate of return (or \$920,902) on the depreciated investment rate base of \$15,348,374 to be fair and reasonable (I App. 39-40, 102). It referred, among other factors, to Petitioner's advantageous position for the marketing of its gas (I App. 40).

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The Supreme Court has stated that the return of a utility should equal that generally being made on investments in

other enterprises with corresponding risks and uncertainties and should be reasonably sufficient to attract the necessary capital and maintain its credit, but that a utility has no constitutional right to profits such as are realized in highly profitable enterprises or speculative ventures. *F. P. C. v. Hope Natural Gas Co.*, 320 U. S. 591, 601; *Bluefield Water Works & Improvement Co. v. Public Service Comm.*, 262 U. S. 679, 692-693; *United Railways v. West*, 280 U. S. 234, 251.

Under this test, the 6% rate of return which the Commission has allowed is clearly reasonable. Substantially the same kind of evidence on rate of return is in this record which this and other courts have uniformly held sufficient to support the Commission's findings on rate of return (Ex. 180, Tr. 5663-5751).¹⁹ *Mississippi River Fuel Corporation v. F. P. C.*, 82 U. S. App. D. C. 208, 163 F. 2d 433 (C. A. D. C.); *F. P. C. v. Natural Gas Pipeline Co.*, 315 U. S. 575; *F. P. C. v. Hope Natural Gas Co.*, 320 U. S. 591; *Colorado Interstate Gas Co. v. F. P. C.*, 142 F. 2d 943 (C. A. 10), affirmed, 324 U. S. 581; *Panhandle Eastern Pipe Line Co. v. F. P. C.*, 143 F. 2d 488 (C. A. 8), affirmed, 324 U. S. 635, rehearing denied, 325 U. S. 834; *Cities Service Gas Co. v. F. P. C.*, 155 F. 2d 694 (C. A. 10), cert. denied, 329 U. S. 773, rehearing denied, 329 U. S. 832; *Interstate Natural Gas Co. v. F. P. C.*, 156 F. 2d 949 (C. A. 5), affirmed, 331 U. S. 682.

The general circumstances frequently considered as bearing upon rate of return are quite similar in the instant case to those referred to by this Court in the *Mississippi River Fuel case*, *supra*, and which this Court found supported a 6% rate of return allowance. If anything, Petitioner's situation is even more favorable than that of Mississippi River Fuel. By the admissions of Petitioner's own witnesses, Petitioner is better situated than the usual natural gas company. It serves a stable and well-established market, consisting, to all intents and purposes of only two customers—Louisville Gas & Electric

¹⁹ Printing of Exhibit 180 has been omitted by special consent of this Court. In addition to the copy included in the transcript of record certified by the Commission, three copies of the exhibit have been furnished to the Court by Petitioner.

Company and Pittsburgh and West Virginia Gas Company (II App. 683). In 1948, sales to these customers by Petitioner accounted for 94% of all gas sold for resale and 96% of its revenues from such sales (Tr. 7752). Petitioner's president testified that Petitioner's "position is unique, not only from the standpoint of amount of reserves available to us but from the standpoint of the proximity of these reserves to the market served" (II App. 127, 682-683), and its operating manager, Beecher, described Petitioner's position in these respects as "enviable" (II App. 198). Its president also testified that even if Petitioner lost its present customers, it would have no difficulty marketing gas in a competitive market (II App. 128).

As this Court stated in the *Mississippi River Fuel case, supra*, the question on review is the "end result" of the rate order (82 U. S. App. D. C. 208, 211-212, 163 F. 2d 433, 436-437). While advancing a general allegation that the order here under review does not meet that test (Pet. Br. 49), Petitioner does not discuss the "impact" or "end result" of the order. A brief summary of the facts pertinent to the "end result" test will show that the 6% rate of return is fair and reasonable.

Petitioner asserts that a reasonable capitalization is 40% debt and 60% common stock (Pet. Br. 46). This capitalization was utilized by Petitioner's rate of return witness (Pet. Br. 46). The record shows that Petitioner's bonds would be rated "A" and that such bonds would require an interest rate of 2.59% to 2.95% (II App. 454). At the 6% over-all rate of return allowed by the Commission, even when using the maximum interest rate of 2.95% for debt, this means a minimum return of 8.03% on the common equity as follows:

	Percent of total capital (a)	Earnings rate (b)	Return re- quirement (a) X (b)
		Percent	Percent
Total capital.....	100	6.00	6.00
Long-term debt.....	40	2.95	1.18
Common.....	60	8.03	4.82

Using 2.59% for debt results in a return on the common equity of 8.27%.

Upon the basis of a more balanced capital structure—50% bonds and 50% common—the return allowed on the equity is 9.04%, using 2.95% for debt, as follows:

	Percent of total capital (a)	Earnings rate (b)	Return re- quirement (a)×(b)
		Percent	Percent
Total capital.....	100	6.00	6.00
Long-term debt.....	50	2.95	1.48
Common.....	50	9.04	4.52

At the interest rate of 2.59%, the return on the common equity is 9.4%.

The evidence presented by the Commission's witness Goubleman, and by Petitioner's own witness Coffman as well, establishes that the return requirement on the equity is not in excess of 8%. For the year 1945, which was still a war year, reflecting the dislocations of the war, Mr. Goubleman's analysis showed an average return requirement on the equity for representative gas companies of 7.93% (Ex. 80, Tr. 5738), and Mr. Coffman's analysis showed an average of 7.88% (Ex. 84-A, Tr. 5324). For 1946, the latest evidence of record, the average, as shown by Mr. Coffman, was 7.28% (*ibid.*), the range being from 6.63% to 8.30% (*ibid.*).²⁰

On either capitalization, therefore, the return allowed the equity meets the "end result" test.

²⁰ The higher over-all rate of return of 7½% testified to by Petitioner's witness Coffman, and the yet higher return on the common equity referred to in Petitioner's brief (Pet. Br. 46-47), were the result of a process involving the use of selected companies and criteria. The results were properly rejected by the Commission since they are based upon the use of an interest rate of 3½% for debt although the witness could not distinguish Petitioner from companies that had been able to finance their debt securities at a 3% interest rate (II App. 434-435); upon companies which had not been in existence for a representative period of time—one of them having been in existence only 45 days and another three months (II App. 513-514); upon unseasoned securities (II App. 530-531); upon stock described as "a radical speculation" (II App. 742); and upon data respecting companies with substantially inflated plant accounts (II App. 749).

CONCLUSION

We submit, therefore, that viewed in any light—from the viewpoint of “end result,” or the component elements of the rate order—the Commission’s orders are valid in every respect and should be upheld.

Respectfully submitted.

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APRIL 1950.

NO. 10401.

IN THE
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FOR THE DISTRICT OF COLUMBIA CIRCUIT

KENTUCKY WEST VIRGINIA GAS COMPANY,
Petitioner,

v.

FEDERAL POWER COMMISSION, Respondent.

On Petition for Review of Orders of the Federal
Power Commission.

**REPLY BRIEF FOR PETITIONER,
KENTUCKY WEST VIRGINIA GAS COMPANY.**

United States Court of Appeals

For the

District of Columbia Circuit

FILED JUN 13 1950

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REPLY BRIEF.

The Reply Brief will be limited to the consideration of the following matters:

I. The inadequacy of the annual depletion allowance for the test year 1948, in the use of the depletion rate previously determined for the test year 1945.

II. Elimination of certain expenses incurred by Kentucky.

III. The end result is not a just and reasonable one.

IV. The legal right to raise all the issues presented in this appeal.

The case of *Mississippi River Fuel Corporation v. Federal Power Commission*, 82 App. D. C. 208, rules the major issues in this appeal. See Petitioner's Brief, pages 25-30.

I.**The Inadequacy of the Annual Depletion Allowance for the Test Year 1948, in the Use of the Depletion Rate Previously Determined for the Test Year 1945.**

The Brief for Respondent, page 19, asserts that there is "no reversal of the Commission's position on proper depletion rate involved". Yet the record clearly shows that the rate for 1948 under the staff's formula—which formula was approved by the Commission—would be 3.64¢ per MCF as contrasted with the rate of 3.16¢ per MCF, the applicable rate for 1945, but applied by the Commission to 1948. The record in this case clearly shows that the application of the formula or equation used by the staff in determining annual depletion will result in a higher rate for 1948 than for 1945. This is conceded in the concurring opinion of Commissioner Buchanan in his statement: (App. 110)

"The record also contained evidence by the staff which indicated an increasing annual depletion rate but lower than the rate shown in the company's evidence".

This situation is also recognized in the dissenting opinion of Chairman Smith of June 20, 1949 in the following statement (Vol. I, App. 103-104):

"Although 1948 is now adopted as the test year for purposes of prospective rate making in respect of other items, it appears that appropriate consideration is not given in the computation of depletion according to the principles approved by the Commission in Opinion No. 168, and the higher recovery costs experienced by the company in 1945 to 1948, as indicated by Exhibit 235, and in reasonable prospect from the year on."

It is also a fact that the staff applying its formula to the year 1944 found an annual rate of 2.88¢ per MCF, and for 1945 a rate of 3.16¢ per MCF, 0.28¢ per MCF higher. See Commission Exhibits Nos. 201 and 202, App. 1287. See also Petitioner's Brief 23-24.

The Respondent's Brief adopts the approach set forth in the concurring opinion of Commissioner Buchanan (App. 109-110), which in effect says that they approve the staff's formula, but refuse to apply it, because estimates of reserves are not acceptable, and because Kentucky has from time to time changed estimates of reserves, and on the average has changed them upward.

The remarkable thing about this case is that this position does not appear anywhere in the majority opinion of the Commission in opinion 168-A (App. 71-81), or in opinion 168-B (App. 85-102). The majority opinion states that they adopt the staff's formula and apply it, opinion 168-B (App. 95):

"With depreciation and depletion expense calculated in accordance with the method and the rates employed in our Orders of September 2, 1948 and November 24, 1948".

The statement is obviously incorrect insofar as it asserts that it has employed the staff "method", because the evidence unquestionably discloses that the application of the "method" will change the rate from year to year as the relevant facts change. The Commission did continue the 1945 rate,—determined under the 1945 facts at 3.16¢ per MCF,—but obviously did not apply the "method" to the facts of 1948, which would produce a different, and a higher rate, 3.64¢ per MCF.

We still contend that the Commission has departed from the method or formula used by the staff notwithstanding what is asserted in the Brief for Respondent.

Let us now consider the merits of the reasons advanced in the Brief for Respondent why the formula was not applied to the year 1948 and why the annual rate was not increased from 3.16¢ per MCF to 3.64¢ per MCF, which the evidence shows to be the correct rate on the application of the formula. The Commission used the estimate of gas reserves of Kentucky for the years 1944 and 1945 and had these estimates checked by the staff who reported a hundred percent approval of the methods used and conclusions reached with respect to these estimates. See Petitioner's Brief, pages 16-18. It was just as well-known in 1945 as in 1948 that estimates were responsive to the best information then available, and that as additional and more complete information became available revisions were made in the estimates. There was no difference in this respect between the situation in 1948 and that in 1945 except that the estimates made in 1948 may have possessed a somewhat higher degree of accuracy than those made in 1945. This is in effect recognized in Respondent's Brief, pages 22 and 23, in the following statement:

"The large lack of adequate information, necessitating constant upward revisions of estimated recoverable gas reserves has, in part, been due to the urgent gas requirements of the war period, when well drilling was accelerated, and when wells, because of the demand for gas, could not be taken out of service to secure the information essential to reliable estimates (I App. 210-212)."

It is, therefore, clear that if the Commission was willing to accept the estimates and apply the formula in

1945, there was no sufficient reason for not applying it in 1948. The Commission likewise had the same opportunity to have their staff check the estimates. The Commission cannot avoid its responsibilities in this regard in 1948 any more than it could in 1945. Since this case does not involve an increase in rates the burden of proof was on the Commission. It cannot change its treatment without reason and without supporting evidence, nor can it jump to the quite obviously incorrect conclusion that if the rate was adequate in 1945 it would be adequate in 1948 and also in 1950.

Estimates of reserves are, of course, an integral part of the staff's formula or equation, and it will continue to be necessary to make estimates from year to year until the wells are exhausted to the economic limit. That is a controlling reason why estimates are made on the conservative side, and should continue to be made on the conservative side; otherwise, the Company might find it had reached the economic limit of recoverability but had not recouped its investment.

The fact that revisions in the estimates are made from time to time as more complete and adequate information becomes available is an inescapable situation which will continue throughout the life of the enterprise. It will have less and less effect as the properties become older, and the facts are better known. It is also clear that the rate will change from year to year under the formula or equation used by the staff, and the undisputed evidence shows that the rate must rise notwithstanding revised estimates, which will, if the estimates are revised upward, only serve to decrease the pace at which the rise will take place. See Petitioner's

Brief, pages 23-24. This is also graphically shown in Petitioner's Exhibits prepared by Mr. Ruemmele, being Nos. 204 (App. 1291), 206 (App. 1318) and 243 (App. 1367). These exhibits show how the depletion rate will rise under the formula or equation used by the staff. Exhibit No. 243 shows the rate rising from 3.16¢ in 1945 to 3.64¢ in 1948, and also shows the further rises as estimated to 1952, when it is estimated to reach 4.77¢ per MCF. If we do not go beyond the question of the proper rate for 1948,—which under the formula is found to be 3.64¢ per MCF,—we are not concerned with the elements of forecasting which are involved in the estimates for the subsequent years 1949 to 1952, inclusive. An estimate for 1948, as we have pointed out, is no different in this respect from that determined in 1945, and is derived from the best data then available, precisely as the estimate was derived from available data in 1945. The point is clearly established that due to increased costs of wells and decreases in recovery from the later wells, the depletion rate will inevitably rise. No estimate is necessarily the final estimate, but notwithstanding these revisions from time to time the rate will rise, not as rapidly if the revisions on the average are upward, but more rapidly if the revisions on the average are downward.

Under the authority of the *United Fuel Gas* case, 5 F.P.C. 279, the Commission should not only make allowance for 1948's increased depletion rate, but also for the increasing rates for the future, since the allowance will be the applicable one during the period of the determined rates. See Petitioner's Brief, pages 31-33.

The Commission has clearly departed from its original position taken in opinion No. 168 of applying the

staff's formula, and it obviously has less excuse to do so in 1948 than it had in 1945, notwithstanding what is stated in the Brief for the Commission.

A word about the calculations prepared by witness Ruemmele for Kentucky, because we feel sure that his calculations correctly follow the staff's formula, and that in deriving the rate of 3.64¢ per MCF for 1948 he reaches the same conclusion that the Commission staff would itself have reached under the estimates. The Commission staff did not make any calculations beyond 1945 — as is pointed out in the Brief for the Commission, page 20—and as a result of this refusal by the staff — under objection by counsel for the Commission to make estimates for the future—Mr. Ruemmele prepared Exhibits Nos. 204 and 206. Before introducing the Exhibits he submitted them to the staff and they approved both the mathematics and the method (II App. 714). They did not either approve or disapprove the projections for the future years because they refused to pass upon this question under instructions from counsel for the Commission. However, it is perfectly evident that the formula or equation is clearly understood by Mr. Ruemmele, and that in preparing his Exhibits Nos. 204, 206 and 243 he has correctly applied the formula or equation. The dispute, if any, really relates only to the accuracy of the projections for the future.

We therefore reach the following conclusions with respect to this matter:

(1) That the use of the staff's formula will always involve estimates of reserves upon the latest and best information obtainable.

(2) There seems to be less reason to question the estimates of gas reserves in 1948 than there was in 1945.

(3) The Commission had the same opportunity and the same duty to have its staff check the estimates in 1948 that it had in 1945. It did not do so, but according to Commissioner Buchanan jumped to the conclusion that it would freeze the 1945 rate for 1948 and subsequent years. The majority opinion does not in any way reveal that they were concerned with the question of the accuracy of the estimate of the reserves in 1948, any more than they were concerned with the accuracy of the estimate in 1945, but, on the contrary, the opinion states that they are still following the staff's "method". This is a mathematical impossibility as the facts disclose, and the Brief for the Commission obviously implies.

(4) We again assert that the Commission has abandoned the staff's formula and has made assumptions with respect to estimates of reserves for 1948 for which there is no warrant in the testimony, and has reached conclusions with respect thereto which are not supported by any evidence but are contradicted by the evidence in this case.

This case must, therefore, be returned to the Commission to determine the proper and appropriate depletion rate for the year 1948, in accordance with the staff's approved method.

Two other aspects of the depletion problem should be further considered.

The refusal to give any weight to the obvious fact that future depletion rates must inevitably be higher

than the 1948 rate, a treatment at variance with the Commission's decision in the *United Fuel Gas* case, *supra*.

Also a further word with respect to the Commission's inclusion of the additional gas which may result from the future deepening of certain existing shallow wells, but its refusal at this time to allow the cost of deepening such wells. The point which we are pressing is not that the company may or may not at some future time when it deepens the well be allowed to recoup that additional investment out of the additional reserves, but that a present injustice is done by arbitrarily increasing the estimates of reserves ahead of the expenditure of the money necessary to acquire those reserves. As we have pointed out, this refusal is in no way related to the merits of the question, but to a technical question of accounting, namely, that money not spent cannot be entered on the books. The difficulty starts, however, when the Commission includes an estimate of 12,600,000 MCF not yet reached by drilling, which, of course, operates to reduce the present annual allowance for depletion. See Petitioner's Brief, pages 33-35.

In this connection it is also of interest to note that the Commission's Brief is now laying great stress upon the possible inaccuracies of estimates of gas reserves, where the drilling has actually taken place and the costs are known and preliminary information is available. Here they are making projections and forecasts for the future for deeper wells to unknown sands at unknown times with unknown costs. The Commission's treatment of this matter is obviously inconsistent, unreasonable and unrealistic. This is long range forecasting of the

most speculative type, where the Commission assumes to determine precise and definite figures, and yet the Commission refuses to accept the estimates of today for events that have already taken place, which are obviously of a far more trustworthy character. There is obviously neither consistency nor justice in the Commission's treatment of these related problems.

II.

Elimination of Certain Expenses Incurred by Kentucky.

The particular items of expense which are disallowed by the Commission as an operating expense, to which further objection is taken, are the items relating to the expenses incurred by Kentucky before the Securities and Exchange Commission. This involves the amount of \$9,224.67 for 1948 and the estimated amount of \$10,000 for each of the years 1949 and 1950. The proceedings before the Securities and Exchange Commission, which are referred to in Petitioner's Brief, pages 37-38, involved the question primarily of whether Kentucky could operate in combination with other companies in the Philadelphia Company System more cheaply than it could operate as a single unit, Kentucky contending that there would be certain economies and savings effected by the combined operations. The refusal to allow these items as proper operating expenses is covered in Respondent's Brief, page 16, as follows:

"Expenditures incurred in trying the issues referred to are not costs related to rendering service to consumers,"

and again that this type of expenditure does not "rightfully belong among costs of service to Kentucky's utility

customers, * * * but is an expenditure which benefits the stockholders alone, in this instance the affiliated companies (I App. 97)." We believe that these assumptions are erroneous in two aspects:

(1) The costs are related to matters which affect service and the cost of the service to customers; and

(2) These are costs which were imposed upon Kentucky by the action of the Securities and Exchange Commission from which it had no escape and they should be allowed as a matter of law.

If Kentucky was right in its contention that the combined operations would effect certain savings and economies, this contention is obviously made for the benefit of utility customers since Kentucky is allowed by the Federal Power Commission to charge only its actual operating expenses. Any saving in these expenses directly redounds to the advantage of the utility customers, no part of which would be allowed to the Company. Kentucky certainly had the right to present its position and its contentions in this respect, and it had a right to incur the expenses incident to the litigation. Furthermore, the expenses incurred by the litigation should be allowed whether they directly redound to the benefit of the utility customer or not. The Company is justified in law in defending itself against attack and in protecting its rights. This question arises whenever the corporation is sued in tort for damages, even though the suit is in no way related to a question directly concerned with service to utility customers. It has a normal right of any corporation to defend itself against litigation, and certainly litigation which is not of its making, and the

costs incurred are proper corporate costs which should be allowed as proper operating expenses; the same applies to taxes. However, as we have pointed out, the essential question involved was whether the combined operations would accomplish certain economies, and therefore whether it was contrary to the public interests to compel the disintegration of these companies. This was a question in which utility customers were directly interested, and if the Company was successful they would be the only beneficiaries. The item of \$9,224.67 should have been allowed as operating expenses in 1948, particularly in view of the fact that estimates for 1949 and 1950 indicated expenses of about the same amount.

III.

The End Result Is Not a Just and Reasonable One.

It is recognized that the Supreme Court of the United States has sustained rates determined by the limited approach of the Federal Power Commission, which, in fact, has adopted one formula and one formula only for rate making purposes, namely, original cost as defined less accrued depreciation. The sole question here is whether the application of that formula can result in a just and reasonable end result, where substantial sums were invested in natural gas properties held in fee, and where there has been a substantial change in the buying power of money, and in the value of these natural gas freeholds.

Kentucky owned as of December 31, 1944, 786,914 acres of natural gas properties held in fee and 182,135 acres under lease, for which it had paid a total amount

in excess of \$3,600,000 (Exhibit No. 148). Most of this property held in fee had been purchased during the latter part of the 1920's. Kentucky offered to prove the present fair value of these properties and to show that the value as of December 31, 1944, was in excess of \$17,000,000 (Vol. II, App. 589).

Most of this money was invested prior to the passage of the Federal Natural Gas Act and when a dollar had a much higher buying power than it has today. Perhaps we can test the question of what is a reasonable and just end result under the circumstances by considering an investor today. Would it be reasonable to assume that an investor today would make an investment in natural gas properties in fee in a substantial amount if he knew that he was going to be subjected to regulation which would deny him any return above 6% if it turned out that he should discover gas in large quantities, and, on the other hand, that he would receive little or no return if it turned out that he discovered only a small amount of gas? Suppose also that he was informed that he would later receive by way of return on his investment and by way of return of his investment, dollars which had much less purchasing power. Purchasing natural gas properties in fee is a speculation venture. Where would be the incentive or reward? To illustrate, let us suppose that the dollars returned to him bought only half as much as the dollars that he invested. Is it reasonable to suppose that an investor would put his money in the property in fee when he could have acquired leaseholds which carried annual rentals or royalties which would be allowed as operating expenses, and in so doing he could put the risk of the investment upon the customers and not upon him-

self? The Brief for the Commission repeatedly refers to the advantages which Kentucky possesses, but gives no consideration to the fact that it has taken away every one of these advantages from the owner of the property and has given them to the customers. The Federal Power Commission recognizes dollars only as dollars without any regard to the buying power of the dollar. In other words, the underlying economics of the situation which should be considered in arriving at a just and reasonable end result are entirely ignored in favor of a mere bookkeeping analysis of the history of the Company, in which dollars are dollars without the slightest regard to the fact that they are not equivalent dollars. It would be equally logical to change the standard of a foot from time to time and buy and sell property by the foot without consideration of the change in the length of a foot.

The Federal Power Commission has frequently stated that depreciation and depletion are determined and allowed so that they will reimburse the Company for its capital investment by the end of the life of the property. *Re Cities Service Gas Company*, 50 PUR (NS), 65, at 80, the Commission said:

"Under that method (for depreciation) the sum required annually to reimburse the Company for the cost of property consumed in whole or in part in rendering service is determined and included in operating expenses with the result that the Company is assured of being fully reimbursed for its capital investment by the end of the life of the property". (Emphasis supplied)

The question, therefore, immediately arises—can the Company be fully reimbursed for its capital investment if the dollars which are given back to it by way of reim-

bursement are less valuable dollars than the ones spent by the Company? Is it not obvious that reimbursement calls for the equivalent amount in value not in pieces of paper denominated dollars? Is it not clear that when the requirement of a just and reasonable end result is mandated, that it means equivalent reimbursement? The real capital investment is the value of that investment in terms of buying power. It is not an aggregation of pieces of paper of varying values denominated dollars.

To illustrate; according to the Survey of Current Business for January, 1950, and the 1949 Statistical Supplement published by the United States Department of Commerce, the purchasing power of the dollar declined 42% from its value in 1940. The decline is obviously greater since the latter part of the 1920's, when most of the purchases of natural gas properties in fee were made. See Exhibits 114 and 115 covering price trends and changes in the buying power of money from 1880 to 1944.

We are not dealing here with the question of reproduction cost or the related question of fair value, as a rate base, which was the issue considered by the Supreme and Appellate Courts of the United States in the cases cited in the Commission's Brief, page 10.

We are in fact considering another aspect of the annual depletion allowance; namely, is the allowance adequate to fully reimburse Kentucky for its capital investment for gas properties owned in fee, unless appropriate consideration is given to the reduced buying power of money? In other words, since the objective of the annual depletion allowance is to fully reimburse the Company for its capital investment, can the fact be

wholly ignored that dollars today are worth much less than the dollars invested, perhaps as to some of the dollars only about 50% or 60% of their invested value? The situation existing in this case, with a large investment in gas properties owned in fee, is a unique one. We have not been able to find that this precise question has been considered or decided in any of the many cases, which have dealt with natural gas rates. Perhaps this is due to the fact that natural gas rights are usually controlled by leases, and are rarely owned in fee.

We are dealing here with a wasting asset which cannot be replaced. If reimbursement is to be made it must be made on a single operation since these natural gas reserves can be captured only once. In this respect, the natural gas business varies from all other utilities. There is one chance and one chance only to recover for the investment. However much the Commission may contend that the investment is fully reimbursed, it is obvious that under the circumstances here it is not fully or adequately reimbursed. If end result has any significance, is it not crystal clear that there is not a just and reasonable end result in this case?

IV.

The Legal Right to Raise All the Issues Presented in This Appeal.

The Commission's Brief in a foot-note, page 3, while asserting that a petition for review should have been filed within sixty days from November 26, 1948 as to those items for which rehearing was not authorized, does not press the matter in behalf of the Commission, but suggests to the Court that it has a "right *sua sponte*

to decline to proceed where jurisdiction does not exist". Certain cases are cited which we do not think rule this case.

We do not agree with this contention and we believe that this Court has jurisdiction to consider all the items involved in the petition for review.

The Order of November 26, 1948 was not a final order on the fundamental issues involved in this rate proceeding but was an interlocutory or intermediate order. While the Commission as a result of the "unsworn data" had in a preliminary way modified its previous order of October 8, 1948, which had provided for a total reduction of \$571,284 to a tentative reduction of \$376,515, it was by no means certain that the final reduction would not be substantially greater. This is revealed in opinion 168-B (App. 89) where the Commission recognizes that on a consideration of the items which had resulted in a tentative reduction of \$376,515, the figures disclosed by the actual operations of 1948 reduced this to an amount not less than \$361,189. In other words, the tentative results derived from the "unsworn data" were subject to further adjustment in the light of the actual operations of 1948. Furthermore, the matters included in Order 168-A for further consideration by the Commission included sub-paragraph (f) alleged "important changes in sales of natural gas which reduced net utility income". This item was not assigned a specific dollar amount because the changes while provided for in contracts made with Tennessee Gas and Transmission Company and with Texas Eastern Transmission Company by both Equitable and Louisville did not immediately affect the "take" from Kentucky by Pittsburgh (which in turn was affected by the "take" from Equi-

table), or by Louisville, and, therefore, specific dollars could not at that time be assigned to the effect of these new contracts, but the ultimate effect was still to be reckoned with, and under the principles applied in the *United Fuel Gas* case, *supra*, these important changes in the source of natural gas would affect Kentucky operations and would gradually tend to reduce Kentucky's income, both gross and net. It was, therefore, quite possible that if the Commission should not consider the effect of these two contracts as too remote and indefinite,—following the approach adopted in its decision in the *United Fuel Gas* case, *supra*,—it would conclude that there should be no reduction in the Kentucky rates. It could also re-consider and re-determine the annual allowance for depletion. In view of such a contingency and the possibility that a decision might be made which would not reduce Kentucky's rates and, therefore, against which it would have no complaint, there was obviously no immediate necessity for or grounds for taking an appeal until these issues were decided.

It is a fundamental principle that in order to appeal from administrative decisions there must be both a "finality of administrative action" and an "exhaustion of administrative remedies". See *American Jurisprudence*, Volume 42, sections 186 to 202, pages 549 to 593, inclusive. Note the following statements pertaining thereto, particularly in sections 194 to 196:

"Courts are reluctant to interfere with administrative action prior to its completion and in this sense not final".

Note also Sections 197 to 202, inclusive, where the rule is stated:

"The doctrine of exhaustion of administrative remedies requires that where administrative remedy is

provided by statute relief must be sought by exhausting this remedy before the courts will act".

Another principle of quite recent origin would seem to decide the issue, namely, that all administrative conclusions must be tested against the concept of a just and reasonable end result. Quite obviously such a test cannot be applied until there is a final decision and a final end result. Courts have always been reluctant to try rate cases on a piece-meal basis. Under the doctrine of the end result it is questionable whether there can be a review until an end result has been finally determined by the Commission.

Furthermore, we think the Administrative Procedure Act of June 11, 1946, clarifies and perhaps disposes of the issue. Section 1009 entitled, "Judicial Review of Agency Action", sub-paragraph (a), provides:

"Any person suffering legal wrong because of any agency action, or adversely affected or aggrieved by such action within the meaning of any relevant statute, shall be entitled to judicial review thereof".

Sub-paragraph (c) contains the following:

"Every agency action made reviewable by statute and every final agency action for which there is no other adequate remedy in any court shall be subject to judicial review. *Any preliminary, procedural, or intermediate agency action or ruling not directly reviewable shall be subject to review upon the review of the final agency action.*" (Emphasis supplied)

The obvious purpose of this provision was to provide the right on final review to consider the preliminary, procedural or *intermediate agency action or ruling*; in other words, to avoid piecemeal reviews.

V.

Kentucky Denied the Essentials of a Fair Trial.

One other aspect of this case should be again pointed out since it has some bearing upon this issue, namely, the lack of clarity in opinions 168-A and 168-B with respect to just what the Commission was deciding and doing on the question of the annual depletion allowance, and particularly the obscurity existing with respect to the reasons therefor. Kentucky was never in a position to understand just what the Commission's position was with respect to the method of determining the annual depletion as reflected in its opinions 168-A and 168-B, and this question still remains obscure and indefinite as to the reasons for the Commission action. As we have pointed out, the positions now taken in the Brief of the Commission and in the concurring opinion of Commissioner Buchanan, which relate the action of the Commission to the alleged inaccuracies of the estimates of the reserves, is in no way revealed in the opinions of the majority of the Commission in opinions 168-A and 168-B. On the contrary, these opinions assert that they have continued to follow the method of determining depletion as previously determined by the staff and approved by the Commission in opinion 168. This obscurity, which has the effect of leaving the petitioner completely in the dark in these important matters, has denied Kentucky the essentials of a full and fair trial, and it is thereby deprived of its legal rights without due process. We still contend that the Commission in effect and without so stating reversed its previous determination with respect to the annual depletion rate,

and then denied Kentucky the right to introduce evidence to show that the assumptions and conclusions reached by the Commission were in error.

The case of *Morgan v. United States*, 58 S. Ct. 773, 23 PUR (NS) 339, 343, 344, 345-346, is in point. On page 343 the Court said:

"The right to a hearing embraces not only the right to present evidence but also a reasonable opportunity to know the claims of the opposing party and to meet them. The right to submit argument implies that opportunity; otherwise the right may be but a barren one. Those who are brought into contest with the Government in a quasi judicial procedure aimed at the control of their activities are entitled to be fairly advised of what the Government proposes and to be heard upon its proposals before it issues its final command."

On page 344 the Court said:

"The requirements of fairness are not exhausted in the taking or consideration of evidence but extend to the concluding parts of the procedure as well as to the beginning and intermediate steps."

On page 345-346 the Court said:

"The maintenance of proper standards on the part of administrative agencies in the performance of their quasi judicial functions is of the highest importance and in no way cripples or embarrasses the exercise of their appropriate authority. On the contrary, it is in their manifest interest for, as we said at the outset, if these multiplying agencies deemed to be necessary in our complex society are to serve the purposes for which they are created and endowed with vast powers, they must accredit themselves by acting in accordance with the cherished judicial tradition embodying the basic concepts of fair play."

Kentucky clearly has the right now to raise all of the issues presented in its petition for review.

Respectfully submitted,

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